THE CRISIS OF THE £

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THE CRISIS OF THE £

BY
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PREFACE

THE National Government has been returned to power but it will be unable to carry its full mandate into effect without inducing an inflation of the currency. Before the Government can be freed from the restrictive influences which will continue to throttle its activities, and which have unduly increased the burden of taxation, a revision of monetary policy will be essential. Why this is so is explained in the following pages.

An early restoration of the £ to mint parity in the exchange markets of the world is an immediate necessity. But a return to the monetary mechanism which existed before 21st September last would be opposed by the industrial and commercial community. It would mean the re-assumption by industry and commerce of the intolerable burden of debt and taxation in terms of gold, from which, whilst an inelastic system of currency is maintained, there is no escape.

Many people support a devaluation of the £ because it will mean a devaluation of Government and Municipal Securities. But it will also mean, if the depreciation of the £ is anchored at about its present level, a heavy loss on our income from foreign investments and invisible services ; also a heavy loss of capital. It is not necessary to devalue currency £s in order to devalue Government and Municipal Securities. Nor is it necessary to await an international conference before we can arrive at a decision to restore the currency to its parity of exchange. If the National Government adopts the correct economic measures, the £ could be restored to its parity of exchange to-morrow, so to speak, without asking anyone's permission. This is as it should be.

If the present depreciation of the £ is anchored at about its present level, it will mean that our effective

currency in circulation will have been, in effect, reduced. Now, a reduction of a currency in circulation means deflation, and deflation means a reduction of employment and of production and consumption. How does the Government propose to deal with this situation ? It may impose import duties on certain classes of manufactures with advantage, but it certainly could not impose duties on agricultural products without disadvantage, since these would induce a rise in the cost of living.

Whilst the present inelastic monetary system is maintained, and the £ remains depreciated at about its present level, a rise in the cost of living is in any event inevitable in view of the increase in cost of importing primary products brought about by the depreciation of the £. This will mean inflation, since it will be necessary to provide additional currency to finance the increased cost and volume of production which is envisaged and the increased cost of primary products. If inflation of the currency were allowed to begin, and symptoms are already evident, no one could foresee the end of it. Inflation can be avoided if the Bank of England pursues a rigid policy of deflation in order to counteract the inevitable rise in costs and prices that will be brought about by the depreciation of the £ and by tariffs. In which event the National Government will be defeated in its objective, and tariffs will be blamed for the failure. The situation is very serious and calls for an immediate solution.

Does the Government feel it is in a position to exercise the full mandate it has received to impose import duties, and consolidate Empire trade ? In my opinion it is impotent to do anything of a material nature in these directions. The Government may impose duties, but nothing of consequence will happen. The final decision in all such matters rests with the City of London, and not with the House of Commons. The Government proposes, but the City of London disposes.

Is the position not indicated in paragraph 391 of the *Report of the Committee on Finance and Industry* as follows :

" In general we are satisfied that, subject to the conditions imposed by the necessity of accommodating ourselves to the outside world, our banking system is adequate and satisfactory in the provision of the normal short credits to industry and their distribution."

Yet within a few months of the issue of this Report we have been forced off convertibility, apparently because we have accommodated ourselves too much to the outside world, and not enough to the industry and trade of the country.

What we need to-day is a National Currency System and not an International one. We have had too much Internationalism and not enough Nationalism. In saying this, it should not be assumed I am not an internationalist —far from it. What I suggest is that before we can become good internationalists we must become good nationalists.

It should not be assumed from what I have said that I am against tariffs on manufactures or on certain classes of agricultural products. All I am saying is that it would be impossible to proceed on these lines without creating greater dangers than the ones we are now faced with. Those who favour the policy of tariffs should above all not run the risk of bringing them into disfavour or disrepute through a wrong application of the policy. They should fight on right ground or not at all. They cannot afford to ignore ' The Dual System of Stabilisation,' of which the Law of Detractions and Promotions is an integral part. The United States and France have applied the Law of Detractions and Promotions with an artistic finish, hence the reason for our present predicament. They have also played the Gold Standard game according to the rules laid down, and forgotten, by London.

A recovery from the low level of depression recently reached may occur. But this will be due to a restoration of confidence in Government administration, to a rise in the value of silver from its low point, and to the artificial stimulus given to the export trade through the depreciation of the £. The improvement that is taking place, in so far as it relates to currency depreciation, cannot be termed an economic improvement. It is largely psychological and artificial. It would be impossible to build a solid edifice of prosperity upon the weak economic foundations which exist at the moment, not only in this country, but in the World generally.

The imposition of tariffs may benefit certain industries, and assist in balancing the Budget. But they will not effect a material improvement in the general position. No economic measure can counteract the implications of the quantity theory of money as developed by an inelastic system of currency.

The restoration of Great Britain's prestige as a first-class Power, and the consolidation of Empire trade, will only be possible if she adopts, with the Dominions, a Central Reserve System. After which it should be Great Britain's aim to co-operate with France and the United States in standardising the mechanism of the system on uniform lines. The defects which exist within the Central Reserve System, as exemplified by the Federal Reserve System, are well known. If these were removed, we should have the finest monetary system in the World, without exception ; and with it the National Government would be free to exercise its mandate in full. Without a reform of the currency system the National Government must remain impotent. The shackles imposed by an inelastic system of currency are too great for any Government to withstand, and there can be no freedom, or distribution of economic justice, until these are removed.

In suggesting that Great Britain should co-operate with the United States and France in the perfection of the Central Reserve System, I do not envisage that an isolated block of these three countries alone should be formed, but simply to regard them as a nucleus for the purpose of giving a lead to the World.

It should be borne in mind that bankers throughout the World already have a great experience of Central Banking practice, and that they would be unwilling to embark on a policy of experimenting with new theories. If we improve and develop what they are doing, and if it means no radical alteration in the practice now followed in the United States and France, progress will be assured. Another point to be remembered is that Great Britain is now committed to tariffs, which, if adopted, would bring her economic policy into line with the United States and France, and that it should be the aim of monetary policy to eliminate all those evils associated with tariffs when imposed under an inelastic system of currency.

Therefore, the policy to be decided is whether Great Britain should substitute an elastic system of currency for the inelastic system now in operation, and, if so, how she may achieve elasticity within the system without endangering stability or departing from well-known and proved banking practice.

Before Central Banking practice could be adopted by India and China, it would be necessary to find a solution of the difficulties which have arisen out of the use of silver as currency. Bimetallism and stabilisation are impossibilities. Proposals based on the 'Dual System of Stabilisation' have already been submitted to and approved by Chinese banking experts, and these are outlined in Chapter XIII. Definite progress has thus already been achieved.

Prominent Australian bankers have also agreed that the 'Dual System' is eminently suitable to Australian

conditions, and that its adoption by Australia would remove many of the difficulties which that country has to contend with at the present time. A large measure of agreement has thus already been reached.

To those who would like to study the ' Dual System more in detail, I would recommend my book, *The Dual System of Stabilisation*, published recently by Messrs. Macmillan & Co. I have written this book as a supplement to the latter, and a synopsis of the complete argument will be found on pp. 124–132. I have included in this book three chapters from the *Dual System of Stabilisation*, with slight corrections, in order to enable readers to appreciate more readily that part of the argument dealt with here.

I have given a new interpretation to the Quantity Theory of Money—it is not what the orthodox economists think it is—and substitute therefor the Quantity Theory of Currency. I have also proved that the fall in World prices is due to a universal contraction of currency—the exceptions being the United States and France—and that the fall in the value of silver is due to this cause. Arising out of this, it can be said that the fall in the value of silver has not directly contributed to the fall in World prices. The most that can be said is that it has had a secondary, or reflex, action. This being the case, bimetallism can be definitely ruled out as a practical solution of the World's currency difficulties. In consequence of the general contraction of currency I demonstrate that there is a definite shortage of commercial credit, if not of financial credit.

I have also taken advantage of the opportunity to lead up to a criticism of the report of the Committee on Finance and Industry.

J. TAYLOR PEDDIE.

LONDON, S.W.1,
7th December, 1931.

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CHAPTER I

THE PROBLEM TO BE SOLVED

THE abandonment by Great Britain and by other countries of the convertibility of their currencies into gold—incorrectly called 'the abandonment of the gold standard' by many financial writers and economists—is raising fresh controversies that require to be focused. The ordinary man in the street is bewildered by the rapidity with which certain economists change their economic views 'to accord with the economic circumstances of the moment.' It is now being generally recognised that there is a 'Science of Money,' and that it controls the destiny of man.

The barter system is invariable and must always remain the base of the 'Science of Money.' It cannot be changed. The barter system has come down to us from the primitive ages, and stated simply, it is the exchange of commodities and services for commodities and services. Through this system only can labour be paid out of the products or services on which it may be employed. The more it produces, and the more wages it receives, the more will it be able to consume. To reduce wages is tantamount to reducing consumption, and ultimately production. The problem to be solved, therefore, is how to increase consumers' buying power, that is, accelerate consumption. I am confident that the only practical solution of the difficulty is the acceptance by the nation of the 'Dual System of Stabilisation,'

as I will endeavour to demonstrate in the argument which follows in the succeeding chapters.

The absence of the right of converting our currency into gold bullion will not impose any hardship on the nation within itself, for its potential productive power and its skilled labour are its real strength. And so long as we retain our competitive power in World markets in our exportable surpluses, which in Great Britain's case must always be manufactures, no harm will accrue; the retention of this power will enable us to restore our currency to parity in the foreign exchange markets of the World. The point now to be answered is whether our present inelastic system of currency will permit of this being done? The answer is definitely—no.

The National Government have deemed it expedient to seek a 'Doctor's Mandate' from the electorate. The Prime Minister has obtained a free hand to impose any measure which may be found necessary to correct the adverse balance of trade and maintain the Budget in balance. The Conservative Party in particular aim to impose tariffs on manufactures and agricultural products, and on this to build a system of Empire Preference.

With the collapse of the £, and while the present inelastic system of currency is maintained, the National Government will be powerless to impose a full range of tariffs on agricultural products, since these would be bound to increase the cost of living, and ultimately costs of production. If this tendency were allowed to develop, inflation of the currency would ensue; if controlled, and if inflation of the currency were prohibited, prices would fall again, or, alternatively, unemployment increase.

In order to ensure a return to stability, it is imperative that the currency should not be inflated, and that the competitive power of the exporting industries should not be impaired. But how long must the National Government remain impotent before it will be allowed

to enforce its mandate. Certain economists are asserting that before the Government will be able to move, it will be necessary to convene a World Conference in order to reach a general agreement on a method for stabilising gold reserves, or some other arrangement for the stabilisation of a general average of World prices. If this view be carried to its logical conclusion, it was surely unnecessary for the National Government to have sought a mandate from the electorate—it should have sought one at Geneva. But how many years would it take to arrive at a World agreement on this question ?

It may safely be taken for granted that no nation of any consequence would be prepared to sacrifice its political independence by taking its orders from a Central Currency Authority located at Geneva, or at any other centre.

There is a certain school of economic thought arising in this country which contends that the United States and France have pursued an extremely selfish policy in the matter of their gold imports. It is held that these should not have been sterilised, but, on the contrary, that they should have been allowed to inflate internal prices. Alternatively, they should have been used to promote loans to foreign countries. This criticism is invalid, and cannot be sustained. The United States and France have played the gold standard game, as exemplified by their own currency systems, and the only way to off-set their advantage is for other nations to follow suit, and this applies with particular force to Great Britain.

The defects which exist within Central Reserve Systems, as exemplified by the Federal Reserve System, are well known. The economists in this country are in agreement with the economists of the United States as to what these are. The simplest way out of her difficulties would surely be for Great Britain to adopt the Central Reserve System without the defects known to

exist within it. After which Great Britain, the United States, and France could then agree to standardise their Central Reserve Systems, perfecting them as far as lay in their power, and thus give a lead to other nations. In this way only will it be possible to build up a true international system.

There is one qualification I have to make. The United States and France should agree to cancel War Reparations, for no longer will Great Britain agree to be the milch cow in this matter. If the United States and France insist on their pound of flesh, then there should be a distinct understanding that they should be paid in goods and not in gold credits. These credits can be arbitraged through the foreign exchanges into currencies convertible into gold, which can then be shipped to either France or the United States. In this way Great Britain and other nations have been drained of their gold. An agreement with the United States and France on this matter is imperative. If these countries do not wish to accept their reparations in goods, then the reparations should be cancelled. France has been extremely clever in the way she has settled her external war indebtedness and capitalised part of her reparations. She should now rest content with the advantage thus gained.

The mistake made by Great Britain has been in accepting imports from the Continent in satisfaction of reparations, and in undertaking to transfer the credits thus created to the United States and France in terms of gold through the foreign exchanges; also in subscribing to reparation and other loans, issued on behalf of Germany and other continental countries, which were obviously not of sound nature. Actually, Germany has not yet paid a shilling in reparations. She has borrowed more than she has paid in reparations, and the balance has been used to strengthen her gold reserves—now largely depleted. The credits she has obtained in

this way have been passed on to France, which has given the latter the power to drain London of its gold.

The London Money Market has received a nasty jolt. It has felt it to be its duty to lend money to needy countries, because it regarded itself as the World's financial centre. It did not stop to inquire whether Germany could repay the money it borrowed, or whether the short-term facilities it had conceded to that country were justified. At the time of the German financial crisis London had £65,000,000 of short-term money in Germany, most of which is no doubt frozen.

British economists have over-stressed the theory that the way to restore prosperity to the World is to lend more. If Germany found it difficult to meet her reparation payments, she was certainly not credit-worthy unless her direct creditors were prepared to accept goods in satisfaction of their reparation and interest claims. The power of Great Britain to absorb imports is limited, and due regard should have been paid to this fact by the London Money Market. Also the fact that credit was convertible into currency, and ultimately gold, should not have been overlooked.

The World is over-borrowing, and too great a strain has been placed on the gold reserves of Central Banks. Nations have been dumping commodities in order to obtain gold credits, from which, for reasons stated, France and the United States have benefited most. What is needed is that borrowing should be restricted, except where required for productive works, and rates of interest should accord more with the pre-war basis. Also Central Reserve Banking should be adopted more extensively by nations, which should be placed in the position of creating more of their own short-term money instead of having to borrow it. The production of wealth alone creates cheap and sound money, provided consumption is

accelerated, which can only be made effective through the provision of adequate re-discount facilities in all countries.

The difficulties with which most countries are faced to-day in balancing their Budgets, and in meeting their debt obligations and fixed internal charges, are due to the extreme fall that has taken place in World prices, and the fall that has taken place in these prices is due to a shortage in the effective means of payment, which in this case means currency. To meet this difficulty it has been suggested that more lending should take place. But as about 50 per cent. of the fall in World prices may be attributed to the severe contraction of currency that has taken place, and to the choking of the credit systems of the World with paper securities, it can be no cure to suggest that credit should be extended. The pyramiding of debts has increased, whilst the consumption of wealth has declined. This clearly points to the need for separating commercial credits from financial credits, so that consumers' buying power may be extended, and so that the weight of debt obligations and taxation may be carried without promoting economic injustice.

The other 50 per cent. of the fall in World prices may be attributed to the fall in the value of silver as a commodity, which fall has been induced in the first instance, as in the case of all other commodities, by the severe contraction of currency that has taken place throughout the World, and notably in India. Had the fall in the price of silver as a commodity not fallen on silver as currency, and had the people of the East not hoarded their wealth in silver, at least half of the World's present economic and political difficulties would not have arisen. About 750 million people in the East have been impoverished, in the first place by the contraction of currency, and in the second place by the fall in the value of silver, and if their purchasing power could be increased

by threepence per week, there would be very little unemployment in England. The exporting industries in England would require to work overtime.

The only cure, therefore, for the World economic depression is to bring about a rise in World prices, particularly the prices of primary products, to at least their cost of production, through an expansion of standard currency, but this will not be possible until we bring about the adoption of a Central Reserve Standard by at least Great Britain, India, and China.

In the subsequent pages I will endeavour to point out what the existing technical defects are, and how these can be remedied.

CHAPTER II

DEFINITIONS OF THE ALTERNATIVE FORMS OF CURRENCY

Before the argument can be developed further we must inquire—What is the Gold Standard? In my book, *The Dual System of Stabilisation* (Chapter III, p. 17), I define the alternative forms of currency as follows:

(*a*) A 'Gold Standard Currency' is one that is covered by an equivalent amount of gold bullion and/or coin held by the Central Bank in its own vaults, or mainly in its own vaults and partly elsewhere. No such currency exists in the World to-day.

It existed in Great Britain prior to 1914, mainly in the form of gold coin in circulation, but the advent of the Great War put an end to it.

(*b*) A 'Pound Standard Paper Currency' is one that is mainly covered by bills of exchange, the eligibility of which has been defined by law, as in the case of the Federal Reserve System. The gold reserves held as cover against this form of currency can be held either in a fixed ratio of 40 per cent. gold to 60 per cent. bills, or, preferably, with an average minimum of 20 per cent. gold bullion held as cover, without any fixed ratio to the bills held as cover against the currency. 'The prestige of gold consists not in being the standard, but in being the best possible reserve for a Central Bank—the most saleable thing in the world with which to settle international balances of account.'

(*c*) A 'Convertible Fiduciary Paper Currency' is one that is partly covered by gold bullion and mainly by Government securities, the gold cover being held to guarantee convertibility of the currency. This system is the one now practised by the Bank of England, and is erroneously called a 'Gold Standard.' It is a 'Mythical Gold Standard.' Of necessity it must be limited in its scope, and, when credit is expanded, inflationary in its tendency. But its inflationary tendency is anchored in its dimension by reason of its adherence to the principle of convertibility, for which purpose

it is expected to maintain a minimum of £150,000,000 gold cover against all issues of the currency. By law, however, the Bank of England is obliged to cover all increases of its note issues by gold, but this provision merely limits still further the inflationary tendency of this form of currency.

In exceptional circumstances, such as those prevailing at present, the Bank can apply to the Treasury for permission to increase the fiduciary issue temporarily, and this expedient has been resorted to.

(*d*) A 'Fiduciary Paper Currency' is one against which only Government securities are held and which in practice is inconvertible. It may ultimately be redeemed out of Government revenue. This form of currency is highly inflationary in its tendency. In the United States, however, it is possible to convert at par the inconvertible portion of the currency of that country into gold by exchanging it into a convertible currency. This is due to the strength of its financial position. In a country whose financial position is not strong, it is possible to effect sales of its inconvertible paper currency at a heavy discount in the foreign exchange markets, and in this way it can be convertible into gold through the convertible currencies of other countries.

A Pound Standard Paper Currency is by far the best of the various forms of currency mentioned, since it is supported by self-liquidating bills of exchange drawn against the necessaries of life, such as wheat, fuel, cotton, wool, and finished and partly finished manufactures, all in course of production and distribution. Such a currency is concerned with commercial transactions and not with financial ones. It effectively sustains what should be the first principle of the barter system, namely—that when we purchase a commodity or service we sell in exchange a measure of value in other commodities, and that when we sell a commodity or service we buy in exchange a measure of value in other commodities. In all cases supply will precede demand—which is the correct principle—and not that demand shall precede supply. Purchasing power will then reside in commodities and services, provided they are measurable in pounds, shillings, and pence. The £ standard will resuscitate to the fullest extent the barter system of economy, and, as a result, it will in itself become the measure of value, *i.e.* the yard-stick of value at 240 pence to the £. . . .

There is a superabundance of wealth in the World, but it cannot be fully distributed. Hence we have what is called over-production. It cannot be fully distributed because there is an insufficiency of wealth behind the currencies of the World. The consequential result is that the barter exchange of commodities and services for commodities and services cannot take place. The present world-wide so-called over-production really means that there is a world-wide insufficiency of currency based exclusively on wealth. Nothing more—nothing less.

Many national currencies have been devaluated. No devaluation of a currency could have taken place if it had been covered to the extent of 100 per cent. in wealth. But what is wealth? Wealth is income. It is made up of the necessaries of life; and the more of it we produce, the more of it we should be able to divide. Wealth is not capital: when capital ceases to produce an income it ceases to be an asset—it becomes a liability. The solvency of all Governments—and their debt holders—depends upon the volume and distribution of their national wealth, and the exchange mechanism that exists for this purpose. In other words, solvency cannot be maintained by borrowing and extending taxation; it can only be maintained by extending production and the power of the consumers to consume.

In this chapter I have confined myself to a discussion of the various forms of currency, and have excluded the substitutes for currency, *i.e.* the credit and cheque system, which, when discussing British monetary affairs, I shall later characterise as credit £s. A clear distinction has to be drawn between what are credit £s and what are currency £s. It will be part of my argument that whilst we may continue to regard the monetary unit as being symbolic in character, we cannot do so without making the currency £s in issue a representative paper currency, and without regulating the volume of credit £s that can be issued in relation thereto.

CHAPTER III

PRICE AND VALUE

WITHIN an inelastic system of currency, prices of commodities are dictated *by the quantity of money available for production and consumption.* The qualification I have introduced is quoted in italics, and it should be borne in mind as the argument develops. Value is created by the producers, and the lowest price at which they can afford to sell without incurring a loss is their cost of production. But as costs of production include the weight of taxation, the producer is entitled to recover these in the value of the goods he produces. We have seen, however, that the larger the output of the producer, the lower the cost of production per unit of goods produced. The service which science and production—and science and production alone—renders to humanity is to assist in cheapening values, *i.e.* it aims at accelerating consumption by lowering the price value of all commodities, subject to profit. When the currency £s in issue are fully covered by wealth in accordance with the Central Reserve Standard advocated herein, price and value will mean one and the same thing (*i.e.* = price-value).

Under a Central Reserve Standard, price should be a numerical expression only, and should indicate the worth in pounds, shillings, or pence of a commodity to be bought or sold. Price should function as an indicator only, *i.e.* it should indicate the price-value of the commodity to be bought or sold. This will be its normal function when the pound is secured on the mass of commodities, and not on the theoretical gold basis it is at present.

In other words, the producers should have the right

to predetermine the price-values of their own productions, such price-values to be calculated on costs of production. No harm can accrue from according the producers this privilege, since price-values will naturally tend towards lowest cost. Under the present inelastic system, the quantity of money—which equals currency and credit—available for production and consumption pre-determines prices (see Chapter IX). If it diminishes in quantity, the price will be less ; if it increases in quantity, the price will be more. A little reflection will indicate that this function of predetermining prices is one which the producers alone should assume, since it also involves wages.

As nothing would have value at starvation point, the base of value must be food production. Wages are paid to Labour to enable it to purchase the necessaries of life. The essence of the situation is that a balance has to be maintained between agricultural and subsidiary industries and all other forms of labour ; and that without this balance price-values would be very easily upset. The stabilising factor which can be introduced is standard currency, which, as I will endeavour to prove in the next chapter, is an invariable measure of value. Without this standard the appropriate balance between agricultural and subsidiary industries and other forms of labour cannot be attained and maintained. And when elsewhere I say that purchasing power emanates from a sale of commodities or services, it must be understood that I envisage the attainment of the appropriate balance, or a position approximating thereto.

CHAPTER IV

THE MEASURE OF VALUE

For the proper conduct of business we require three kinds of measurement—length, weight, and value. In the case of length, we have the yard-stick ; and in the case of weight, we have the scales. In order to avoid fraud, the Board of Trade appoints inspectors of weights and measures to enforce the observance of these units. But so far we have no effective measure of value. And the reason for this is, that economists have drawn no clear distinction between the 'Standard of Value' and the 'Measure of Value.' These two expressions are usually taken to mean one and the same thing.

When gold circulated as currency, it acted as a standard and measure. The gold content was the standard, and the weight the measure. But it has been found to be physically impossible for all countries to have a gold coin circulating as currency, so that those which existed have been withdrawn, except in the U.S.A. and South Africa, where, strange to say, the Dollar standard and a £ standard prevail. These countries have no gold standard, yet they have the power to maintain gold coin in circulation, which is wholly attributable to their rediscounting system. But the maintenance of gold coin in circulation can yield no advantage.

When economists say that the standard of value consists of so many grains of gold, they make a statement which is not true ; for the grains of gold constitute the mint parity, which is the measure of value. Gold as a commodity is the standard, but as a commodity it is certainly not the measure. The confusion of thought

which exists in the minds of students of the subject is, in most cases, due to the use of wrong terminology by economists.

In so far as Great Britain is concerned, the measure of value should be the paper £, and, provided the £s in issue are fully covered by eligible bills drawn against wealth products, it should be invariable in itself. If covered by wealth, why should we wish to sell our paper £s at less than their face value? The £ note should represent 240 pence worth of purchasing power over the mass of commodities, and, as such, it should be the measure of value. Price-values may change from day to day, but this should not affect the invariability of the £ measure as currency.

In this matter of currency, Professor B. M. Anderson, the distinguished American economist, in his book, *The Value of Money* (p. 133), writes as follows in criticism of Nicholson's dodo-bones:

> I do not deny that if the traders used the dodo-bones as counters, agreeing that such dodo-bones should represent some other commodity chosen as a standard of values, that the dodo-bones would circulate. But, in that case, they would be, not primary, self-sustaining money, but merely representative, or token money. And just here let me lay down two general propositions respecting the two main functions of money: to serve as a standard, or common measure, of values, the article chosen must, as such, be valuable. The thing measured must be either a fraction or a multiple of the unit of measurement. But this quantitative relation can exist only between *homogeneous* things. The standard, or measure, of values, then, must be like the commodities whose values it is to measure, at least to the extent of having *value*. The second proposition is respecting the medium of exchange. The medium of exchange must also have value, or else be a representative of something which has value. There can be no exchange, in the economic sense—I abstract from disguised benevolences, accidents, and frauds—without a *quid pro quo*, without value balancing value, at least roughly, in the process. Now when it is remembered that the intervention of the medium of exchange,

taking the place of barter, really breaks up a single exchange under the barter system into two or more independent exchanges, and that the medium of exchange is actually received in exchange for valuable commodities, it follows clearly that the medium of exchange must either have value itself, or else represent that which has value. These two propositions seem almost too obvious to require the statement, but they contradict the quantity theory, and they are not, on the surface, reconcilable with certain facts in the history of inconvertible paper money. It is necessary, therefore, to state them, and to examine further some of the phenomena which seem to contradict them. If they are true, Nicholson's dodo-bones will perform neither of the primary functions of money. They have no value, *per se*—they cannot, then, measure values ; they are neither valuable nor titles to valuable things—they are not *quid pro quo* in exchange, and will not circulate.

With these views I largely agree, but it should be observed that Dr. Anderson draws no distinction between the 'standard' and 'measure' of value. Under the 'Dual System' the paper £ note becomes not only the measure of value, but an invariable one. It acquires this virtue by reason of the fact that in part it actually represents circulating commercial credit, secured on the mass of commodities—which are the real cover for the note issues—through the medium of commercial bills rediscounted at the Central Bank. It has, in fact, already been established as an invariable measure before its issue, and it has to be acquired by someone to be paid back to the Central Reserve Bank to redeem a commercial credit. It is the only instrument that will be accepted by the Central Bank in discharge of the credit. It is a representative currency, but a stabilised one, and thus the only one that can act effectively as a measure of value.

Under these conditions we conform to the requirements of the seller of commodities or services, both for internal and external trade. The seller would be prepared to accept the £ note freely in payment, in the confident knowledge that it would pass from hand to hand at

full face value. Confidence is the basis of credit, and this is the only real virtue that gold possessed as currency, or as the basis of currency ; but we know now that it was an extremely limited one.

There is a great difference, however, between the paper £• as a measure of value for all British trading transactions and gold as a unit of measurement for international currencies. In the former we can create sufficient £s to measure all British commercial transactions. Purchasing power emanates from a sale of commodities, and purchasing power need not be contracted because of a lack of measures. The measures should be able to penetrate every corner of the kingdom, and it is here that gold as a measure has failed. Its spread was not sufficient. Mill was of the opinion, which I will refer to later, that if more gold were wanted to promote a larger barter economy, all we had to do, in order to maintain stability of prices, was to acquire more gold. We were then, of course, the only gold standard country in the World, and could acquire all we wanted since we were the only buyers of gold for currency purposes. But when gold became an international currency, it became the most unstable measure conceivable for national purposes, because there was, and is still, an insufficiency of it for monetary purposes in all countries on orthodox lines.

Gold, as I conceive it, is now only useful as a unit of measurement for international purposes. It is really now only a mint parity. The quantity of gold necessary to act as reserves against the currency should be held at the Central Reserve Bank. It is the only commodity that can be conveniently handled, and compactly stored, at a Central Bank. Hence the reason why we must continue to use it, but in the very much more limited way suggested. When this plan is developed there will be a sufficiency of gold in the World for use as reserves by Central Banks.

CHAPTER V

GOLD AS AN INTERNATIONAL CURRENCY

UNDER normal trading conditions, and excluding for the moment reparation payments, credit, and investment operations, one of the consequences of a free gold market is that gold becomes an international currency ; hence foreigners may sell us goods in exchange for gold credits, and not for goods. The economic principle that imports should pay for exports ceases to be effective. Should the purchasing power of gold be less in Great Britain than in other countries, it will be transferred to those countries where it will be greater, *i.e.* where it will buy more. The absurdity of this arrangement is manifest. The gold reserves of the Bank of England are used as the basis of credit in this country—the more currency there is in issue, the more credit can the banks create—yet it is open to any foreigner to exchange his credit into gold and ship it abroad, and thus enforce a contraction of credit and trade activity in Great Britain. It should be borne in mind that on each £100 of currency held by the banks, they are able to pyramid approximately £1,000 of credit. A withdrawal of £1,000,000 of gold would enforce the contraction of approximately £10,000,000 of credit.

The undesirability of maintaining gold as an international currency is obvious. The currency of a country should only be convertible into gold at the will of a Central Bank, and not at the will of an individual holder. If this regulation were enforced, the difficulties which most countries now experience in maintaining convertibility would soon disappear. But to ensure of its smooth

working the adoption of a Central Reserve Standard by all countries would be necessary.

Gold should only act as the medium through which prices are converted from one currency to another, that is, foreign exchange transactions should be carried through on the basis of mint parities ; and a sufficiency of the metal need only be held to ensure convertibility, or provide security, to any Central Bank that may require it. In other words, gold should be used as the unit of measurement for foreign exchange purposes, and not as the measure of value for internal purposes. A maximum gold reserve of 20 per cent. against the volume of currency—not in a fixed ratio to the volume in issue—should be sufficient for all reasonable purposes, provided the currency is effectively divorced from Government finance, which it would be if it were entirely covered by eligible bills of exchange.

While gold remains an international currency it would be impossible to have universal free trade. The doctrine of free trade implies a barter system—that is, the exchange of commodities and services for commodites and services. But it should be confined to exportable surpluses. If an import of commodities into a country only results in the creation of bank credit convertible into gold, the credit will be transferred through the foreign exchanges to other countries where its purchasing power may be greater, or where primary products may be obtained in preference to manufactures, or manufactures in preference to primary products. Alternatively, the gold itself may be preferred by foreign countries in order to extend the base of their monetary systems. International trade to-day is like a concertina arrangement—constant contraction and expansion of the metallic base of monetary systems. And the nation which is clever enough to avoid any contraction of its gold reserves will grow the most prosperous. This proposition has only to be stated, to

show the absurdity of free trade based on metallic money.

Where imports of commodities are received for the purpose of discharging a debt it is an advantage, provided the imports are non-competitive ; no imports should be received in those commodities in which the country's productive power is strongest, and in which it is capable of creating an exportable surplus. Where such imports are received it will cause unemployment.

The obvious cure for the defects here outlined is for the nations of the World to group themselves into large economic units, each economic unit to have a common measure of value, and a single government. If it were impossible to form a single government, it would be impossible to have a common measure of value, for no nation, or group of nations, would be prepared to lose its political independence. The real advantage to be derived from the creation of a large economic unit such as the United States, to which reference has frequently been made, is not that it is a self-contained free trade unit, but that it has a central government and a common measure of value based on the mass of consumable commodities. The United States has made more progress since it adopted the Federal Reserve System in December 1913, than it made in the previous years of its existence, if we measure such progress by the growth of deposits held by its banks.[1]

Universal free trade is not the ideal conception mankind should have before them. Nations can only trade in their exportable surpluses. Bartering what they do not want for what they want. Free trade and freedom of trade are not the same. The true ideal is the production and consumption of wealth, and each nation should be permitted to reach the highest social standard attainable without the restrictions imposed by metallic money. The Socialist ideal is that the people should own the

[1] See pp. 105–7 : *Dual System of Stabilisation.*

wealth they produce. Where the Socialists make the mistake is in assuming that it is necessary for a government first of all to create and own the wealth. This is not the function of government. The people will own all the wealth they produce whenever they are able to possess an invariable paper measure of value, which will only be possible when it is covered to the full extent of its face value by consumable wealth. The people may then barter with each other to their hearts' content. This will be freedom of trade, and usury, as we know it to-day, will be unknown.

There would be a great danger in forming large economic units if they were to tend to exclude the smaller nations from acquiring their due share of primary products from the tropical and temperate zones. No harm could accrue, however, if the principle of bartering exportable surpluses in commodities and services for commodities and services were maintained, which standard currencies alone could ensure. Nations large and small could then obtain their due share of the wealth which God has placed at the disposal of all.

CHAPTER VI

THE PURCHASING POWER VALUE OF A CURRENCY SHOULD INCREASE FROM AN INCREASE OF ITS ISSUE

THE most significant and illogical feature associated with the majority of currency systems in the World to-day is that an increase in the purchasing power value of a currency depends upon a decrease of its issue (this we know as deflation), whereas a decrease in the purchasing power value of a currency is brought about by an increase of its issue (this we know as inflation).

But I think I have clearly demonstrated in my book, *The Dual System of Stabilisation*, that an increase in the purchasing power value of a standard currency should not depend upon a limitation of its issue, but upon an increase of its issue. A currency note should be the measure of value only, and, as such, it should be invariable not only in itself but in its purpose. This is the reverse of all orthodox teaching, but it is a sound doctrine nevertheless.

If a currency be expanded, according to the orthodox interpretation of the 'Quantity Theory of Money,' prices will rise. But let us follow the sequence of events in order to test the truth of the interpretation. An expansion of currency presupposes an increase of demand. An increase of demand presupposes an increase in the volume of production. An increase in the volume of production presupposes a decrease in the cost of production of each unit produced, subject to the law of increasing returns. Any producer will confirm this elementary proposition. Puzzle : Why, then, should prices rise ?

The answer to the puzzle is that an expansion of fiduciary currency and bank credit is not the same thing

as an expansion of standard currency and regulated credit; one is inflation and the other is not.

The confusion no doubt has arisen from the fact that currency is convertible into credit, and credit into currency, but this is just where the defect arises. When bank credit is inflated it has not the same quality as currency, if the latter be convertible into gold. When bank credit is inflated, securities rise in value, and the holders of these convert into wealth whilst the going is good, as and when they can. This competition for wealth, in an inelastic currency system, brings about a rise in commodity prices and capital values such as property and works of art. In a stabilised elastic currency system, a regulated expansion of credit will bring about a rise in the prices of luxury services and works of art only, and not to so great an extent in property and securities. No rise can take place in commodity prices.

The proposition which I have laid down depends upon our having a Central Reserve Standard wherein credit is controlled and not currency. An expansion of the latter will not raise prices, since price will always tend towards lowest cost. An expansion of currency under a Central Reserve Standard would really mean an expansion of circulating commercial credits, in which all from the lowest to the highest would share. There are many more people without bank accounts than there are who have. The chief means of payment among the working classes must always remain the currency note and token coins, and not the cheque. And the more wages they have, the more currency will they have in their pockets to circulate. The more they are able to spend, the more will consumption be accelerated, which should be the true aim and end of monetary science. This aim can only be attained if all expansions of financial credits are regulated, for reasons which I have already indicated.

CHAPTER VII

IS CURRENCY AND CREDIT EQUAL AS MONEY ?

It is commonly supposed that currency and credit are equal as money, but I will now endeavour to prove that this is not so. The mistake has no doubt arisen from the fact that currency is convertible into credit, and credit into currency. Although there are a few inconsistencies in the writings of John Stuart Mill, yet it can be said that he did not include credit in his conception of the 'Quantity Theory of Money,' as may be observed from the following quotation :

> The proposition which we have laid down respecting the dependence of general prices upon the quantity of money in circulation must for the present be understood as applying only to a state of things in which money, that is gold or silver, is the exclusive instrument of exchange and actually passes from hand to hand at every purchase, credit in any of its shapes being unknown.—*Principles of Political Economy* (vol. II, p. 19).

I deal with the modern interpretation of the orthodox 'Quantity Theory of Money' in Chapter IX, but how the modern interpretation has arisen I cannot conceive.

In my view prices would not rise from the 'state of things,' outlined by Mill, since an increase of demand would increase the volume of production, and thus reduce the cost of each unit produced. And if it were known that the quantity of gold coin in circulation were constant, producers would be certain to regulate their production to it. If the gold coin were to be increased, then the producers would increase their production to correspond, and still Mill's 'Quantity Theory' would be wrong. Mill would be right if he referred to a paper currency un-

covered by wealth in any form, but quite clearly he excludes inconvertible, or convertible, fiduciary currency.

But does not Mill confirm my view in his own words, in the following :

> Let us suppose that the quantity of commodities produced is not greater than the community would be glad to consume : is it, in that case, possible that there would be a deficiency of demand for all commodities, for want of means of payment ? Those who think so cannot have considered what it is which constitutes the means of payment for commodities. It is simply commodities. Each person's means of paying for the production of other people consists of those which he himself possesses. All sellers are inevitably *ex vi termini* buyers. Could we double the productive powers of the country, we should double the supply of commodities in the market : but we should, by the same stroke, double the purchasing power. Everybody would bring a double demand as well as supply : everybody would be able to buy twice as much, because everybody would have twice as much to offer in exchange (vol. II, p. 93).
>
> If values remain the same, what becomes of prices is immaterial, since the remuneration of producers does not depend on how much money, but on how much of consumable articles, they obtain for their goods. Besides, money is a commodity ; and if all commodities are supposed to be doubled in quantity, we must suppose money to be doubled too, and then prices would no more fall than values would (vol. II, pp. 93–4).

Many people will no doubt wonder why Mill should assume that gold could be doubled if the production of commodities were doubled, and the explanation is, that in his day Great Britain was the only country that had a gold standard. Her gold currency in those days was a National Currency, and not the international one it is at present.

Nevertheless, what becomes of his theory 'that an increase of the quantity of money (gold and silver coin) raises prices, and a diminution lowers them' ? In his argument he assumes that if commodities are doubled, money will be doubled too. But surely if gold and

silver coin are doubled, commodities will be doubled too. In this argument I am conforming to his qualification 'that credit in any of its shapes' should be excluded.

A further inconsistency in Mill's argument is to be found in the following :

> Money acts upon prices in no other way than by being tendered in exchange for commodities. The demand which influences the prices of commodities consists of the money offered for them (vol. II, p. 51).

But he has already told us that in fact commodities constitute the means of payment ; and that, excluding credit, prices would be determined by the producers of commodities, and not by money. This part of his argument is the true one, and I think he confirms it in the following:

> We have seen that the value of everything gravitates towards a certain medium point (which has been called the Natural Value), namely, that at which it exchanges for every other thing in the ratio of their cost of production (vol. II, p. 91).
>
> The larger the scale on which manufacturing operations are carried on, the more cheaply they can in general be performed (vol. II, p. 255).

Now let me introduce the real intervener in the 'Quantity Theory' as described by Mill, which again, I think, confirms my view that currency and credit are not equal as money.

> In the case, however, of payment by cheques, the purchases are at any rate made, though not with money in the buyer's possession, yet with money to which he has right. But he may make purchases with money which he only expects to have, or even pretends to expect. He may obtain goods in return for his acceptances payable at a future time ; or on his note of hand ; or on a simple book credit, that is, on a mere promise to pay. All these purchases have exactly the same effect on price, as if they were made with ready money. The amount of purchasing power

which a person can exercise is composed of all the money in his possession or due to him, and of all his credit. For exercising the whole of this power he finds a sufficient motive only under peculiar circumstances ; but he always possesses it ; and the portion of it which he at any time does exercise is the measure of the effect which he produces on price.

Suppose that, in the expectation that some commodity will rise in price, he determines, not only to invest in it all his ready money, but to take up on credit, from the producers or importers, as much of it as their opinion of his resources will enable him to obtain. Everyone must see that by thus acting he produces a greater effect on price than if he limited his purchases to the money he has actually in hand. He creates a demand for the article to the full amount of his money and credit taken together, and raises the price proportionately to both. And this effect is produced, although none of the written instruments called substitutes for currency may be called into existence ; though the transaction may give rise to no bill of exchange, nor to the issue of a single bank note (vol. II, pp. 52–3).

In these two latter quotations Mill reveals the true reason why, under an inelastic system of currency, prices rise from an increase in the 'quantity of money.' There are currency £s and credit £s, and, whilst the expansion of the latter is unregulated, they cannot be equal as money. Why this mistake should have arisen and have been allowed to pass is a puzzle. I am still, of course, conforming to Mill's thesis that currency is equal to gold and silver. What happens in the case of a fiduciary currency I deal with later on.

The development of our present monetary technique has been brought about by the doctrine developed by Sir Robert Peel, and later by the orthodox economists, that if you will adhere to the standard of value, and will adopt such measures as shall ensure the uniform equivalency of bank notes to coin, you may safely leave untouched other forms of paper credit and entrust the regulation and control of them to individual caution and discretion.' This doctrine enlarges the rule laid down

by Mill, with which enlargement, I think, he would not have agreed. It is clear from what I have said that we cannot leave the regulation and control of the expansion of financial credits to individual caution and discretion. It is here that the World has gone wrong.

When Sir Robert Peel made his statement in 1844—it should be noted that he refers to gold as a standard of value and not as a measure of value—we were then the only Gold Standard country in the World, and we continued to remain so until 1874. After the latter year Germany, France, the United States, and other countries followed suit, and when the competition for gold began in 1874, there began an acute period of depression in this country, due to its acceptance of imports in exchange for its gold and not for its merchandise. In other words, the principle that imports paid for exports ceased to be effective.

The unqualified view that a regulated currency and unregulated credits equal money must be discarded. If we insist that the currency should be covered to the extent of 100 per cent. by wealth, and if we permit an inordinate expansion of credit to take place, and allow credit to circulate as money through the cheque system, we place the holders of currency at a disadvantage. In common parlance, we rob them. Under Central Banking practice based on the rediscounting system, expansions of currency promote a falling costs level subject to profit, which is certainly not inflation. But under the same system, expansions of currency extend the base of financial credits, and if the latter were expanded on existing ratios, inflation of an inordinate character would ensue. The implications of the 'Quantity Theory of Money,' therefore, as they are commonly understood, require adjustment. When Central Banks are able to control the ratio at which financial credits may be expanded, we can then regard currency and credit as being equal from a monetary point

of view. This point is extremely important, since only from its general acceptance will Central Banks be able to work with gold reserves not exceeding 20 per cent. of their currency issues and deposits. When the World reaches this stage there will be a sufficiency of gold for monetary purposes.

The finest monetary system that any country can possess is Central Banking practice based on the re-discounting system. The nearest approach to the perfect system I have in mind is the Federal Reserve System, but, owing to the inability of the Federal Reserve Banks to control the activities of all the national and state banks in the United States, grave defects have arisen within the American Monetary System in recent years, and particularly since 1929. It should be noted I have said the 'American Monetary System' and not the 'Federal Reserve System.' The reason why I wish to draw this clear distinction is that the Federal Reserve System only controls the commercial system of banking, and not the financial system of banking. Only 26 per cent. of the 25,000 National and State banks in the United States are members of the Federal Reserve System, and until the latter is able to have a 100 per cent. control over all the banks in the United States, it cannot be said that the Federal Reserve System is fully established in that country. And until it is fully established it will not work effectively. Another great defect is that there are far too many small banks in the United States. If Branch Banking were developed as effectively in that country as it is in this country, it would make for greater efficiency. This is generally recognised in the United States.

Because of the absence of effective control, it must not be said that the Federal Reserve System has not proved to be as successful as its promoters hoped it would be. The only monetary ideal before the world to-day, and of which it has had experience, is Central Banking practice

based on the re-discounting system, within which the commercial system of banking should be completely divorced from the financial system. When this is effectively realised, we shall have the 'Dual System of Stabilisation.' Expansions of currency will then never be able to influence prices, which will be determined solely by the volume and cost of production. In other words, 'Price' and 'Value' will cease to operate as separate factors, and 'Price-value' will take their place.

I am indebted to the *Midland Bank Monthly Review*, October–November 1931, for the following record of suspensions, by numbers and aggregate deposits, since 1921. In the same table there is shown, for reference at a later stage, the division of the failures into two groups, differentiating those banks which were or were not members of the Federal Reserve System.

DEPOSITS IN $ MILLIONS

Year.	Total Suspensions.		Member Banks.		Non-member Banks.	
	Number.	Deposits.	Number.	Deposits.	Number.	Deposits.
1921 . . .	501	196	70	43	431	154
1922 . . .	354	111	57	24	297	86
1923 . . .	648	189	124	51	524	137
1924 . . .	776	213	159	74	617	139
1925 . . .	612	173	146	67	466	106
1926 . . .	956	272	160	69	796	204
1927 . . .	662	194	124	66	538	128
1928 . . .	491	139	73	42	418	96
1929 . . .	642	235	81	57	561	177
1930 . . .	1,345	865	187	380	1,158	484
1930 (8 months) .	609	263	79	68	530	195
1931 . . .	932	699	203	282	729	417

The first point arising from the table, apart from the black record of 1930–31, is the small average size of the banks concerned. A casual glance at the relationships will show that in almost every period, whether reference be made to the totals or the group figures, the average deposits involved were well below one million dollars per failure—an almost incredibly small sum for an institution designated as a bank.

It is useful here to place on record the trend of the numbers of banks in existence in recent years, divided, for later reference, into groups according to the laws under which they operate. In the same table are shown the aggregate deposits, exclusive of inter-bank balances, of all banks.

	National Banks.	State Banks.	Total.	Deposits ($ millions).
June 30, 1921 . .	8,147	21,950 [1]	30,097	35,742
Dec. 31, 1925 . .	8,048	20,209	28,257	49,224
1929 . .	7,403	17,227	24,630	55,289
1930 . .	7,033	15,736	22,769	53,039

It will be seen that the total number of banks has declined considerably during the past nine years as a result of amalgamations and failures, the heavier decline occurring in the state group. Meanwhile, total deposits have risen on balance, so that the average size of the banks has increased somewhat. Nevertheless, the average deposit total per bank is still only $2½ millions, as against an average of well under one million among those banks which have failed.

At the end of last year the membership of the Reserve system consisted of about 7,000 national banks and 1,000 state banks, leaving 14,700 state banks outside. Thus expressed, however, the relationship is deceptive, for it may be said, roughly speaking, that most of the large banks are members and most of the small ones non-members. . . . It is commonly stated that one of the contributory weaknesses leading to the large aggregate of bank failures is the lack of cohesiveness in the relationships between central and trading banks. Support for this conclusion may be found in the table near the beginning of this article, from which it will be seen that by far the larger proportion of failures has occurred among non-member banks.

There may be many more failures yet to come—there always have been many failures yearly—but these will not shake the foundations of the system, which are essentially solid and well laid.

I concur with the views expressed by the Midland Bank.

[1] The number for 1921 is not strictly comparable with those for later dates.

The Chairman of Lloyds Bank, in the course of his last annual speech, made the following observation:

> A distinguished American banker and economist, in answer to the accusation that the United States had rendered its gold sterile, recently made this retort: 'Our net gain in monetary gold from 1914 to the end of 1929 was about 2,500 million dollars, and the increase in outstanding bank credit was over 37,500 million, or about 15·5 dollars of new credit for each dollar of new gold. Whatever that may be, it is not sterilisation!'

No. I agree. But it was certainly strangulation. The expansion of member and non-member bank credit should not have exceeded a ratio of 9 to 1. Whoever the distinguished American economist was, he forgot that the day would soon arrive when the borrowers of the inflated credit would wish to convert their inflated securities into currency, or actual wealth of some sort. And that in the scramble to realise capital values would fall precipitately.

When capital values fall precipitately, bank failures ensue in cases where they have not been able to maintain margins. This begets, as it did in the United States, a hoarding of currency. This, together with the recognised shortage of currency throughout the world, begets a deflation of security prices and capital values as well as commodity prices. The reflex action of all this is that when the producers get no return on their capital and labour, the basis on which all security prices rest gets extremely narrow. New buyers are not able to enter the capital markets. Credits as a consequence get frozen. If there were no wealth, nothing would have value. At starvation point all values disappear, and in all considerations of this question this is the point we have to bear in mind.

Confirmation of this view is to be found in the following

extract taken from *The Federal Reserve Bulletin*, October 1931:

The President of the United States, on 7th October, after consultation with leading bankers and representatives of both political parties, issued the following statement:

'The prolongation of the depression by the succession of events in Europe, affecting as they have both commodity and security prices, has produced in some localities in the United States an apprehension wholly unjustified in view of the thousandfold resources we have for meeting any demand. Foolish alarm in these sections has been accompanied by wholly unjustifiable withdrawal of currency from the banks. Such action results in limiting the ability of the banks in these localities to extend credit to business men and farmers for the normal conduct of business, but beyond this, to be prepared to meet the possibility of unreasoning demands of depositors, the banks are compelled to place their assets in liquid form by sales of securities and restriction of credits so as to enable them to meet unnecessary and unjustified drains. This affects the conduct of banking further afield. It is unnecessary to specify the unfortunate consequences of such a situation in the districts affected both in its further effect on national prices of agricultural products, upon securities, and upon the normal conduct of business and employment of labour. It is a deflationary factor and a definite impediment to agricultural and business recovery.

'There is no justification for any such situation in view of the strength of our banking system and the strong position of our Federal Reserve System. Our difficulty is a diffusion of resources, and the primary need is to mobilise them in such a way as to restore in a number of localities the confidence of the banker in his ability to continue normal business and to dispel any conceivable doubt in the mind of those who do business with him.'

In order to show the distrust which depositors had of their credit dollars, and presumably the distrust traders had of cheques, I need only mention that the currency in circulation in the United States increased between the months of March and October this year from $4,607,914,000 to $5,539,519,000.

Professor B. M. Anderson, in his book, *The Value of Money*, 1917 (pp. 496–512, Chapter XXIV), illuminates

the position still further. The following quotations will be of interest :

In traditional discussions of banking, the impression is given that commercial paper is the normal and dominant type of banking assets. To one accustomed to this view, the figures of the Comptroller of the Currency for banking investments in the United States for 22,491 banks of all kinds (State, national, private, and savings banks, and trust companies) in 1909 will occasion dismay :

	$ (000,000 *omitted*).
Loans on real estate	2,505
Loans on other collateral security	3,975
Other loans and discounts	4,821
Overdrafts	69
United State bonds	792
State, county and municipal bonds	1,091
Railroad bonds and stocks	1,560
Bonds of other public service corporations	466
Other stocks, bonds, etc.	703
Due from other banks and bankers	2,562
Real estate, furniture, etc.	544
Checks and other cash items	437
Cash on hand	1,452
Other resources	111
Total resources	$21,095

These figures, however, call for further analysis. They include figures from institutions which should not be counted with commercial banks. The percentage of real estate loans, especially, is too high to represent the workings of commercial banks, a very high percentage of real estate loans being held by stock and mutual savings banks. The other items, however, are not much changed by the inclusion of savings banks and private banks. It will be well to draw some conclusions from these aggregate figures for all classes of institutions, before taking up a more detailed analysis of State and national banks, and trust companies.

Where, among these items, does one find commercial paper?

On p. 510 Professor Anderson illustrates the development of bank loans on stock exchange collateral for three or four decades preceding 1909, and in a footnote he mentions that the figures are typical of the proportions of the items in the assets of the three classes of institutions for the ten years from 1904 to 1914. The following are the figures which he states illustrate the tendency of National Bank loans in New York City :

	Loans on Commercial Paper.	Advances on Securities.
1886 . .	$146,000,000	$107,000,000
1904 . .	$268,000,000	$538,000,000

The tendency is not peculiar to America, however. The following tables give a classification of the loans and discounts of all the great European banks in selected years from 1875 to 1903.

(*Figures in francs,* 000,000 *omitted*)

	Commercial Loans.	Advance on Securities.	Note Circulation.
1875 . .	4,027	828	9,699
1903 . .	6,147	4,129	16,539

From these figures it will be seen that the note circulation expanded by 70 per cent., financial credits by 500 per cent., and commercial credits by 50 per cent. only. Later statistics led to the conclusion that the ratio of the World's commercial credits to the total credits issued varies from 12 per cent. to 24 per cent. The latter may be taken as being the maximum figure. I do not think it exceeds 20 per cent.

I am not blind to the fact that a great deal of the borrowing which takes place under advances on securities finds its way, in the long run, into production and consumption. But I have already shown that it leads to inflation, and the objective we now have in view is to eliminate all inflationary and deflationary tendencies from monetary mechanism, that is, to promote stabilisation,

so that a more equitable distribution of wealth may take place.

In order to bring Professor Anderson's views up to date, I have extracted the following quotations from an article of his written in *Lloyds Bank Monthly Review*, May 1930. I make no excuse for the lengthy quotations in view of the importance of the subject :

There is gold enough in the Central Banks of the World to make it easy to supply all the bank credit that is needed for legitimate business purposes. And the annual additions to the gold stocks of the World are ample to meet the legitimate needs of business expansion. But there is not enough gold in the World to enable us to continue the unsound things which we have been doing in recent years, during which expanding bank credit has been used as a substitute for investors' savings on a colossal scale, financing the mortgage market, financing the building trade, financing the one-sided flow of goods in the export trade, and, above all, financing a stock market speculation which was insatiable in its demands for credit.

The problem of the cash reserves of an individual bank, and the problem of the gold reserves of the banking system of a country, are merely part of the more general problem of the liquidity of bank assets. The bank whose general assets are highly liquid needs less cash than the bank the bulk of whose assets are slow. The country whose banks place the bulk of their resources in highly liquid form can get along with much less gold than the same country would require if its banking assets were chiefly slow and illiquid loans and investments.

Bank credit remains liquid most easily when it is not excessive, and when bankers are in a position to insist upon the usual banking standards of liquidity in extending credit. When bank credit is very excessive and rapidly increasing, as was the case with us on a vast scale between 1921 and the middle of 1928, bankers are faced with the alternative of having idle funds on hand, or of placing them in unusual uses. During this period in our own banking history, bank holdings of real estate mortgage loans increased by over 200 per cent. There was a great increase in bank holdings of instalment finance paper. Banks bought bonds, including foreign bonds, in great volume. Bank collateral loans against stocks and bonds, including foreign stocks and bonds, increased with great rapidity. Between 1921 and 1928, bond holdings, plus stock and

bond collateral loans, of the 'National banks' (*i.e.* those chartered by our Federal Government) increased from 42 per cent. to 55 per cent. of their total loans and investments, while for the six hundred odd 'reporting member banks' in the great cities (representing about 48 per cent. of our total commercial bank resources) the ratio rose from 46 per cent. to over 60 per cent. Commercial paper, eligible for rediscount at the Federal Reserve Banks, declined greatly in percentage, and even declined in absolute amount, during this period.

I will not go so far as Professor Cassel seems to do, in holding that bank money should never be used for capital purposes to supplement current savings, but I do maintain that this source of capital has been terribly overdone and abused in recent years, and that we cannot continue it at the present rate. Nor do I concur in his proposition that a high bank rate would necessarily compel real savings to be used to repay bank advances. Over-expansion of bank credit reflects itself on both sides of the bank's balance sheet. Deposits rise as well as loans and investments. If a high bank rate compels liquidation of bank credit, with depositors using deposits which are the product of bank expansion, rather than of savings, to buy at attractive prices the securities held by those to whom the bank has made the advances, enabling the bank advances to be paid off, the pressure may be so much removed from the existing volume of bank reserves as to permit a new and desirable expansion of bank credit flowing into commercial channels. Both loans and deposits go down in such a liquidation, and the reserve ratio is improved. American banking in the old days was rather regularly accustomed to operations of this sort. When funds became inadequate both for commerce and for the stock market, we liquidated stock market loans in order to increase commercial loans.

The fundamental solution of the problem of a comparative shortage of *gold* is to be found in increasing the mobility and the liquidity of *goods*, through less restricted international trade. When nations interpose serious obstacles to the receipt of goods from one another, a great deal of the export trade is handled on the basis of long credits, which either make slow loans in banks, or else require the exporting country to take foreign bonds. These credits must grow from year to year to provide for new exports, and to provide for interest on previous credits. The country which has an excess of gold can expand bank credit for a time in such a way as to take care of this. Exporting countries which are short of gold find increasing difficulties in doing it. In any case, it is an impos-

sible basis for permanently satisfactory export trade. When, however, goods can move with adequate freedom from country to country, and when exports can be paid for with imports, a very different situation is presented. Short-time, self-liquidating credits, largely on an acceptable basis, can then take care of a great volume of export and import business, and the World's supply of gold is abundantly adequate for that. We can economise gold by increasing the mobility and liquidity of goods.

Under the 'Dual System of Stabilisation' it is not proposed to restrict the financial system of banking in any way. On the contrary, the lending power of the member banks will be increased, but there will be imposed a definite fixed limit beyond which they may not lend. If this limit should ultimately be found to be too great, then the Central Bank will have power to reduce the ratio, a more effective procedure than the one now followed, namely, raising the Bank Rate, which penalises all producers and traders.

What the new system ensures is that producers and traders will have access to commercial credit, as if the financial system of banking did not exist. And this will harm no one. On the contrary, everyone engaged in finance, industry, and trade will benefit.

Apart from the need for obtaining greater re-discount facilities, it should be borne in mind by all concerned that industry will require access to the capital market, so that it may obtain what it needs for the reorganisation, or extension, of plant and trade. In order that the capital obtained may retain its marketability and liquidity, ample financial credit facilities should be made available. To this end the lending power of the banks should be increased, but on lines that will promote stability. It is as important to the banks to maintain the marketability and liquidity of the securities on which they may lend as it is to maintain the liquidity of commercial bills.

But it is for the Central Reserve Bank to ensure that

when credit £s are converted into currency, whether through the instrumentality of securities or cheques, that the holders of currency are obtaining full face value in exchange. One of its primary duties is to ensure the maintenance of sound banking principles, and the convertibility of the currency, whether to securities, credit, or gold, is one of them.

CHAPTER VIII

IS THE FALL IN WORLD PRICES DUE TO A SHORTAGE OF CREDIT ?

A GREAT deal of misapprehension has arisen over the question of the price-level. Some reviewers of my book, *The Dual System of Stabilisation*, are afraid that I am out to stabilise prices about their present level, and are of the opinion that we should aim at getting back to the 1929 level. Both views are mistaken. We should aim at getting back to a price-level that will enable employment to be maintained at its maximum, good wages to be paid, and production carried on at a profit. My thesis always assumes the establishment of normal working conditions, and this will come about automatically whenever the active currency in circulation throughout the World is adequate for the needs of production and consumption.

It is from the acceleration of consumption alone that we can hope to raise prices to their economic level. World productive power can supply the needs of World populations. But the World's monetary systems do not provide the populations with a sufficiency of the effective means of payment, that is, measures of value; hence the reason why prices have been deflated. Until there is a sufficiency of currency throughout the World no one could possibly determine what the price-level should be, or could be. In concerning themselves with the maintenance of price-levels at a given point economists are beginning at the wrong end, and if their views were to prevail they would prevent the establishment of working conditions of a natural order. First principles should come first.

The main argument used by bankers against a reform of the monetary system on the lines proposed is that there is no evidence of a shortage of credit facilities, and that the fall in the general level of World prices is not traceable to a shortage of credit. If they mean financial credit, their assertion is true if it be confined to the economic circumstances of the moment. But the volume of financial credit required to-day is considerably less than it was two years ago. Prices of securities have fallen considerably. There is, however, a definite shortage of commerical credit as measured by the active currency in circulation. These points I shall prove later on. Furthermore, the free currency in circulation is the consumer's credit as well as the producer's credit.

The fall in the value of silver as a commodity from 89 pence to 16 pence has alone brought about a shortage of currency in China—and a contraction of the base of credit in India—inasmuch as the fall in price is equal to a deflation of the purchasing power value of silver as currency , on top of this the Government of India has mistakenly brought about a severe contraction of currency. According to Mr. Paras Nath Sinha, B.A., of the Federation of Indian Chambers of Commerce, there has been a contraction of the active currency in circulation in India, between 1st January, 1920 and 7th February, 1931, of no less than 131 crore of rupees, which, taken at the exchange rate of 1*s.* 6*d.*, equals £98,250,000. A shocking state of affairs in a country with such a large population as India. I discuss this question further in Chapter XIII.

In recent months several economists of standing have endeavoured to prove that the fall in world prices was due to a shortage in the means of payment (which includes currency, cheque, and other substitutes), while other economists and financial writers have endeavoured to prove the contrary.

The apparent conflict of opinion has arisen from the fact that both sides speak in terms of money, which equals credit and currency, and not in terms of currency alone, which is the only effective means of payment. Credit is a non-circulating medium, whereas currency is an active circulating medium, and, in most countries, is the chief mode of payment. As envisaged by the economists, the means of payment include all substitutes for currency. But I have shown that at starvation point all values disappear ; likewise, if the volume of credit in issue remained the same, and all wealth disappeared, credit and substitutes for currency would have no value. It should be borne in mind for the purpose of this argument that wealth should be currency, and currency should be wealth. In other words, credit to-day would have no value unless it were convertible into currency, or unless the innocent public converted their currency into credit. Hence the reason why banks open so many branches in order to attract savings. It is for them a necessity, and I do not blame them. I am simply criticising the system.

Lord D'Abernon gave an address to the members of the Royal Empire Society in May last year, in the course of which he endeavoured to prove that the fall in world prices was due to a shortage in the means of payment. In a criticism of his address the financial editor of *The Times* wrote as follows :

> Lord D'Abernon is in error in supposing that wholesale prices have fallen because the volume of credit has declined. The deposits in the banks to-day are larger than they were in 1926 or 1928. . . . The volume of bank credit, therefore, cannot be the cause of the fall in prices. Even if the monetary machine created fresh credit there is no certainty that the credit would be used in purchasing wholesale commodities.

This argument is a recapitulation of the banker's statement, that there is no evidence of a shortage of credit

facilities. But, as I will endeavour to prove later on, and particularly in the next chapter, if credit is expanded at the same time currency is contracted, prices will fall. Likewise, if the volume of bank credit is maintained by the simple expedient of lowering the cash ratio, this will not prevent a fall in prices, if the currency has been contracted. In order that this point may be proved, the statistics on p. 43 should be studied very carefully.

The amended statement showing the variations of the active currency in circulation between the years 1919 and 1931 is the most interesting. I have here, I think, established a definite relation between currency and prices. It should be observed that in the case of 'Deposits with Clearing Banks' there was a fall in the volume of deposits between the years 1921 and 1925 of £181,000,000, while the total of the 'Active Currency in Circulation' declined in the same period by £62,200,000. The wholesale price-level also declined from 197·2 to 159·1 during the same period. So far the fall in prices coincides with the contraction of credit and currency.

It is when we come to deal with the later period that we obtain confirmation of my general thesis. Between the years 1925 and 1930[1] 'Deposits with the Clearing Banks' increased by £163,000,000, while the 'Total of the Currency in Circulation' declined still further by £48,700,000. This is the period referred to by *The Times* above. Notwithstanding the increase in bank deposits, which equals credit, the wholesale price-level continued its fall from 159·1 to 119·5, thus keeping in step with the contraction of the currency.

Now let us apply a further test. If we take the extreme years 1921 and 1930, we find that in the latter

[1] I have limited myself to the latter year in consequence of the monetary disorders prevailing in 1931, in order to show more clearly the cause of those disorders.

Bank of England
(£ Millions)

Year.	Notes in Circulation. Currency Notes and Certificates Outstanding (a)	Notes in Circulation. Bank of England Notes.	Notes in Circulation. Total.	Bank of England Notes in Currency Notes Redemption Account.	Notes in Banking Dept of Bank of England (Reserve)	Total of Notes Issued.	'Proportion' of Reserve to Liabilities (Banking Department).	Bankers' Deposits.
							%	
1919, Oct. 29	336·6	82·7	419·3	1·75	20·3	441·3	15⅞	76·2(c)
1920, Nov. 3	356·0	109·7	465·7	18·75	11·7	496·1	9⅞	75·1(c)
1921, Nov. 2	313·7	105·7	419·4	19·45	19·9	458·8	15¼	85·7(c)
1922, Nov. 1	288·0	102·0	390·0	21·15	20·9	432·0	18⅜	68·8(c)
1923, Oct. 31	281·3	102·3	383·6	22·45	20·8	426·8	19	67·8(c)
1924, Oct. 29	285·0	101·1	386·1	22·45	22·8	431·4	19¾	71·0(c)
1925, Oct. 28	291·6	86·7	378·3	56·25	25·2	459·8	23¾	64·8(d)
1926, Oct. 27	287·6	82·8	370·4	56·25	31·9	458·6	27⅜	66·6(d)
1927, Nov. 2	294·2	80·3	374·5	56·25	32·9	463·7	28¼	64·2(d)
1928, Oct. 31	291·6	78·3	369·9	56·25	48·7	474·8	42⅝	62·8(d)
1929, Oct. 30	(b)	358·8	358·8	(b)	32·2	391·0	30⅛	58·1
1930, Oct. 29	—	355·6	355·6	—	63·9	419·5	58 7/32	55·7
1931, Oct. 28	—	356·0	356·0	—	54·6	410·7	41 29/32	63·5

(*a*) Since 1920, notes and certificates outstanding include notes called in but not yet cancelled.
(*b*) Note issues amalgamated 22nd November, 1928.
(*c*) Estimated. (*d*) October average.

Amended Statement showing Variations of Active Currency in Circulation, 1919 to 1931 inclusive

Year.	Bankers' Deposits (Bank of England) (less Proportion Reserve).	Currency Notes in Circulation.	Total of Active Currency in Circulation. (d)	Wholesale Price Index (a) (Board of Trade).	Cost of Living Index (a) (Ministry of Labour).	Deposits with Clearing Banks.	Ratio of Cash to Deposits.
1919, Oct. 29	62·1(b)	419·3	481·4	—	215	—	—
1920, Nov. 3	65·6(b)	465·7	531·3	307·3	249	—	—
1921, Nov. 2	70·5(b)	419·4	489·9	197·2	226	1,846	11·9
1922, Nov. 1	54·2(b)	390·0	444·2	158·8	183	1,729	11·6
1923, Oct. 31	52·9(b)	383·6	436·5	158·9	174	1,670	11·7
1924, Oct. 29	54·8(b)	386·1	440·9	166·2	175	1,674	11·5
1925, Oct. 28	49·4(c)	378·3	427·7	159·1	176	1,665	11·6
1926, Oct. 27	43·4(c)	370·4	413·8	148·1	172	1,686	11·6
1927, Nov. 2	46·0(c)	374·5	420·5	141·6	168	1,747	11·4
1928, Oct. 31	35·9(c)	369·9	405·8	140·3	166	1,790	11·0
1929, Oct. 30	40·5	358·8	399·3	136·5	164	1,802	10·7
1930, Oct. 29	23·4	355·6	379·0	119·5	158	1,828	10·4
1931, Oct. 28	36·9	356·0(e)	392·9	103·8	147	1,724	10·2

(*a*) Yearly averages.
(*b*) Approximate estimate—no record available. (*c*) October average.
(*d*) Currency in circulation and bankers' deposits, less proportion reserve at Bank of England.
(*e*) Includes an increase of the Fiduciary Issue by 15 millions—under Treasury minute—as a temporary measure.

year 'Deposits with the Clearing Banks' were only £18,000,000 less than in the former year, although, as above mentioned, a sharper decline took place in the years between. Yet when we turn to the 'Total of the Active Currency in Circulation' we find that between the years 1921 and 1930 there was a decline, or contraction, of £110,900,000. If we make comparisons with 3rd November, 1920, we find that the difference is more marked, for the decline between 1920 and 1930 comes out at no less than £152,300,000.[1]

Now let us look at the 'Ratio of Cash to Deposits.' We find that between the years 1920 and 1925 they remain comparatively steady, but this is attributable to the fact that the volume of deposits declined. But after 1925—in view of the contraction of the currency—the bankers evidently agreed to increase their lending power and deposits by working on a lower cash ratio, *i.e.* cash basis. The ratio has gradually declined since 1925. But as I have mentioned above, though they ultimately increased their deposits between the years 1925 and 1930 by no less than £163,000,000, the increase in credit did not stop the decline in the price-level nor prevent Great Britain being forced off the gold standard.

The extraordinary feature of the situation is that owing to the monetary system being starved of currency, and to the pressure on our gold reserves occasioned by the high costs level prevailing in this country, our bankers have been inviting foreign short-term deposits, presumably with a view to preventing a further contraction of the currency. The withdrawal of these deposits is indicated in the 1931 returns, and in a frantic effort to make good these losses, and prevent Britain being forced off the gold standard, the Bank of England and the Treasury, between the months of July and September of this year,

[1] Compared with the highest point reached on 29th December, 1920, the decline is not less than £175,000,000.

borrowed on short term in New York and Paris no less than £130,000,000. Under proper mechanism our own short-term money, which would have been the better of the two, would have cost nothing. Yet bankers would seem to have persisted in preferring foreign short-term money, and paying a heavy rate of interest for it, with a view to obscuring the defects of the present system.

This relationship between currency and prices is very definite. In the month of March 1920, when the authorities began to deal with the inflation which existed as a consequence of the War, credit was contracted and the Bank Rate raised to 7 per cent. The raising of the Bank Rate cost the Government and traders of the country £26,000,000 during that year. It also brought about a considerable fall in the market value of all classes of securities. Yet the contraction of credit and the raising of the Bank Rate were ineffective in reducing the cost of living, which reached its highest point in November of that year. The currency in circulation reached its highest point in December 1920, and this is the true explanation.[1] It was not until the Government began to balance its Budget that the authorities were able to begin a contraction of the currency. At the time the policy was commendable because the currency in circulation was purely fiduciary and inconvertible.

This piece of history is useful in proving that it is the contraction and expansion of fiduciary currency that influence commodity prices, and not the mere contraction or expansion of the credit pyramided on it. Expansions of financial credit mainly affect security values,[2] and

[1] See *The Dual System of Stabilisation*, pp. 1–3.

[2] 'The year 1928 was notable for the buoyancy of the London market, prices generally showing a rising tendency. No fewer than 283 new issues of ordinary, preferred, and deferred shares, and of industrial debentures, were brought out on the market. The depreciation suffered by the investor since is equal to 42 per cent. on the amount originally invested, which equals £48·7 million.' (Vide *Economic Journal*, December 1931.)

expansions of fiduciary currency commodity prices.[1] But, as I have previously explained, when a currency is fully covered by wealth, commodity prices are solely determined by the volume and cost of production. The implications of the 'Quantity Theory of Money,' in so far as they affect commodity prices, are thus neutralised ; the break between currency and prices is definite ; and in so far as they affect security values, they are stabilised, if the ratio at which financial credits may be expanded is controlled. Inflationary tendencies are thus definitely removed. At the present time, however, owing to monetary disorders, security values have been abnormally depressed, and, like commodity prices, they should be restored to their proper level. This could not be regarded as inflation.

The frequency with which transactions may take place in the course of a year in the process of barter is called by economists 'rapidity of circulation.' But as such transactions are primarily concerned with currency and not with credit, and if it be true to say—as it is—that the more efficient the currency becomes in its circulation the more prosperous will the community become, why should it ever be necessary to contract the volume of currency in order to contract, or limit, the volume of credit ? An efficient standard currency never yet imperilled a banking system. The failure of banks is generally traceable to unwise lending of credit on financial securities. What the World is suffering from to-day is from a slowing down of the blood-stream—that is, efficient currency circulation. It is thus misleading to suggest, as *The Times* has done, that an increase of credit, based on the lowering of the cash ratio on which it is pyramided, is equivalent to

[1] When the currency is contracted, production, consumption, and profits decline. Thus the base on which security values rest diminishes. This will bring about a decline in security values, notwithstanding any expansion of bank credit.

increasing the efficiency of the currency circulation. Economists should be careful to distinguish between a shortage in the means of payment and a shortage of standard currency.

Nations are trading with each other to-day in surplus products for the purpose of obtaining credit balances which they hope to convert into gold. It is a case of beggar my neighbour. These short-term credit balances are a menace, and a great source of weakness, to any monetary system. If each nation had a standard currency in being which would ensure that imports really paid for exports, the game of beggar my neighbour would soon come to an end. It is the deficiency of effective purchasing power within a nation which compels it to seek markets abroad.

The fact that the total currency in circulation within the nation may only be at the ratio 1 to 5 of financial credit does not invalidate the argument. In an elastic system, as I envisage it, the currency will pass from hand to hand, and will finance numerous transactions in the course of its circulation. Its sole function will be to act as a circulating measure of value. It will accurately measure the purchasing power which emanates from a sale of commodities, but it will not restrict the volume of production, and, above all, its consumption. From this we conclude that when a contraction of currency takes place, it means that a contraction of purchasing power, production, and employment will take place. If the people were able to improvise a substitute for the legal means of payment, which alone enables them to carry on their trade of barter, these things would not happen, but they are prevented by law from doing so. We pride ourselves on our freedom, but there is one thing in which producers and consumers have no freedom to-day, and that is to barter their commodities and services for commodities and services. They are mere slaves to the monetary machine. They have to bear

all the losses and obtain very little of the profit. It is a world phenomenon, and it is not peculiar to this country alone.

I should also like to state here that no comparison can be made with the pre-war currency position, since banks now require a larger volume of cash at the base of their credit structure in order to maintain the larger volume of financial credit which they have to lend against Government and other securities. Furthermore, when such credit is issued against Treasury Bills, Government and other fixed interest-bearing securities, it will not in itself raise the prices of these securities. Prices of such securities, and of equity shares, will only rise if there be a plentiful supply of cheap standard currency of our own creation. Money should then be available in the money market at a rate of interest lower than the yield on securities.

These last two paragraphs amplify the argument in the preceding chapter.

CHAPTER IX

THE QUANTITY THEORY OF CURRENCY

I HAVE a few further observations to make to Chapter XXI in the *Dual System of Stabilisation* dealing with the 'Quantity Theory of Money.' I shall attempt here to prove that there is really no 'Quantity Theory of Money,' but that there is a 'Quantity Theory of Currency.' *The Times* has recently published three articles under the heading 'The Financial Crisis,' evidently written by an economist of standing. In the first of these articles, which *The Times* has since published in pamphlet form, the writer defines the 'Quantity Theory of Money' as follows:

> According to this theory in its simplest form, the general level of prices at any given moment is determined by the relation of the amount of goods in process of production and distribution to the amount of money in circulation. The total quantity of these goods is always worth exactly the total quantity of money. Hence, if the quantity of money is increased without any corresponding increase in the total quantity of goods, the goods are worth more—in other words, prices rise. If, on the other hand, the quantity of money is diminished without a diminution in the quantity of goods the total quantity of money will be worthless—in other words, prices will fall. Now for the purposes of this argument 'money' must be interpreted broadly as including all the regular means of payment, that is to say, not merely coin and bank notes, which we may call currency, but also credit, *i.e.* bank deposits drawn upon by means of cheques—the method by which, in a financially civilised community, the majority of payments are transacted.

The error here is 'that the total quantity of these goods is' not 'always worth exactly the quantity of money,' because, of the total quantity of credit issued (commercial and financial), at least 80 per cent. is

financial and 20 per cent. commercial. By no stretch of imagination could financial securities be classified as 'goods in process of production and distribution.'

Whenever a currency is covered by wealth, as would be the case under the 'Dual System,' the volume of goods in circulation could have no relation whatsoever to the volume of currency in active circulation, nor to the quantity of money (money being equal to currency and credit), the reason being that the currency in circulation would simply act as a measure of value, and pass from hand to hand in the processes of exchange. When commodities and services are being bartered for commodities and services, how could it be possible for anyone to record the numerous transactions that could take place, and to say that the value of the transactions was exactly equal to the quantity of money? There would be just as much sense in saying that the total material measured by the yard-stick was equal to the value of the material used in all yard-sticks and tape measures.

Even within our present inelastic monetary system, it would be difficult for the writer in question to maintain his interpretation of the 'Quantity Theory.' It is, of course, a universal error.

As I said in the corresponding chapter in my last book, the orthodox interpretation of the 'Quantity Theory,' 'stated in its simplest form, is, that prices will vary in accordance with the volume of work which the quantity of money may be called upon to perform. If the quantity of money remains the same, and the quantity of production is increased, prices will fall (deflation). If the quantity of money is increased, and the quantity of work remains the same, prices will rise (inflation).' This is the most we can say of the orthodox theory. It would be absurd to place the wider interpretation upon it as the writer above-mentioned, and other modern economists, have attempted to do.

The reason why prices rise under our present inelastic system is that financial credits constitute the bulk of the total credit issued. Purchasing power is manufactured, and it certainly does not emanate from a sale of commodities. If, therefore, the quantity of money is expanded through credit, and we send the people into the market place with their unregulated credit £s, prices will assuredly rise.

This argument presupposes that all expansions of credit under present inelastic monetary systems are conducted in the correct orthodox manner. Since 1925 expansions of credit have taken place in Great Britain simultaneously with a contraction of the currency (see Chapter VIII). In consequence of this, prices of commodities have not risen; on the contrary, prices have fallen. Bankers have had to resort to the expedient of working with a lower cash ratio because of the contraction of the currency (see p. 43). The mere fact that bankers have had to resort to this expedient in order to put the best possible face on the currency and credit situation does not invalidate the 'Quantity Theory of Money' as it arises out of present inelastic monetary systems. In lowering their ratio of cash to deposits bankers have simply weakened the credit structure, and the implications arising therefrom cannot be used as arguments against what is a scientific fact, namely—that an expansion of credit based on an expansion of currency will raise prices. It will also do so if the quantity of currency remains the same, assuming there is an adequacy of currency in circulation. It should be understood that in this paragraph I am simply defending the implications of the orthodox Quantity Theory, with a view to giving it a correct focus.

The essential need of the moment is that we should neutralise the implications of the 'Quantity Theory of Money' in order that the stabilisation of commodity

prices may follow. I am aware that I have myself said that the quantity of money should be increased proportionately with the volume of production, but I have always implied currency, and have laid stress on the word 'proportionately.' I could not possibly suggest, even under the 'Dual System,' 'that the total quantity of goods is always worth exactly the total quantity of money.' It would have no foundation in fact.

As Mill has said, 'each person's means of paying for the production of other people consists of those which he himself possesses.' This may be commodities, or the purchasing power which emanates from a sale of commodities. According to the orthodox economists, however, if he be hard up, and his credit is good, he may go to a bank and obtain a loan in return for the payment of interest. Finally, the loan would be placed to the credit of the borrower in his deposit account, and thus what starts as a debt becomes a credit. And wonderful to behold the aggregate of such debts, or credits, together with the active currency in circulation and other means of payment, are exactly equal to the volume of goods in course of production and distribution. This is the present orthodox argument, but how the trick is worked I cannot comprehend. No wonder economic science has been called a dismal science. I am not surprised at the bankers saying there is no evidence of a shortage of credit facilities.

Let us assume that £1,000 of the active currency in circulation carried through one hundred transactions in the course of a year, then the total value of the commodities sold would amount to £100,000, and by the end of the year most of them would have been consumed, or cleared off the market. How then could it be said—even excluding credit transactions of the kind mentioned in the preceding paragraph—'that the total quantity of these

goods is always worth exactly the total quantity of money' at any given moment of time, or at any other time? The theory is too absurd to justify even a moment's consideration, yet it prevails, and, because it does so, it has become the source of the unending monetary disorders and social unrest which exist throughout the World.

I am quite willing to agree that the 'Quantity Theory of Money' as expounded by the modern orthodox economists has some foundation in fact, namely—that of injustice. But it has no foundation within a Central Reserve Standard as exemplified by the *Dual System of Stabilisation*, and I will endeavour to explain why this is so. Let us assume that the producers of this country had discounted bills with their bankers to the extent of £200,000,000, maturing in, say, six months time, and that these bills had been rediscounted by the bankers at the Central Bank, and, as a consequence, an equivalent amount of currency was brought into being. Now, legally speaking, the currency would have to remain in circulation for six months, pending the production and consumption of the commodities which originated the discount; and, if the contractual obligations were fulfilled by the Central Bank, the break between currency and prices would be complete.

But let us further assume that it were possible for the Central Bank, three months before the maturity of the bills, to withdraw £100,000,000 of the currency which it had contracted to allow to remain in force for six months, then I agree the so-called 'Quantity Theory of Money' would apply, that is, the producers would be left with the full production they had undertaken in a market shortened of £100,000,000 of purchasing power, in which event they would be forced to realise at a very great loss. This would be called 'deflation.' But if such an event happened it would be due to an illegal act and not to a

natural cause. The Central Bank would have broken its contractual obligation—a contingency not likely to occur, but we are assuming it for the purpose of the argument. It is only because such contractions of currency frequently occur within currency systems based on metallic money that the 'Quantity Theory of Money' retains the foothold it has. It is open to Central Banks to withdraw currency in circulation regardless of the consequences which such action entails on producers and consumers, because it is under no legal obligation to maintain the currency in circulation at a given level for a given time. Before it can contract credit under existing mechanism, it has to contract currency. Thus producers and consumers have no security whatsoever as regards the morrow.

> Consumers in constant fear that they cannot get enough, and producers in constant fear that they will produce too much.[1]
>
> It is the buyer for consumption, not the buyer for production, who controls the whole chain of processes. Consumers never stop buying because they fear a slump in the market for producers goods: producers often stop buying because they fear a slump in the market for consumers' goods.[1]
>
> Enough buyers to take away the current output of finished goods is a project upon which everyone can unite with enthusiasm, for it looks not only to the welfare of each and every class . . . indeed, if consumer buying were adequate, decade after decade, no considerable group of the population could possibly fail to gain some share of the resultant increased output, for most of it would have to be distributed as larger real wages and larger real profits.[1]

I cannot do better than conclude this argument with parts of the argument developed by Mill, and referred to in the preceding chapter. The conclusions are final and unalterable, if the correct monetary mechanism be employed:

> All sellers are inevitably *ex vi termini* buyers. Could we double the productive powers of the country, we should double the supply of commodities in the market; but we should, by the same stroke,

[1] *Business Without a Buyer*, by Foster and Catchings.

> double the purchasing power. Everybody would bring a double demand as well as supply; everybody would be able to buy twice as much, because everybody would have twice as much to offer in exchange (*Principles of Political Economy*, vol. II, p. 93).
>
> If the values remain the same, what becomes of prices is immaterial, since the remuneration of producers does not depend on how much money, but on how much of consumable articles they obtain for their goods. Besides, money is a commodity; and if all commodities are supposed to be doubled in quantity, we must suppose money to be doubled too, and then prices would no more fall than values would (vol. II, pp. 23–4).

In using the word 'money' in this argument Mill was careful to point out that he meant currency, that is, gold and silver only, 'credit in any of its shapes being unknown.' And as 'everybody would bring a double demand as well as supply,' with which I agree, what then becomes of the orthodox interpretation of the 'Quantity Theory of Money'?

The relationship which may exist between the quantity of money and the amount of goods in process of production and distribution, should not enable the former to dictate the prices and volume of the latter. Certain relationships will produce bad tendencies, while others will produce good tendencies. The relationships which exist between money and wealth should be so shaped as to produce good tendencies.

Acting upon this principle, I have evolved the 'Quantity Theory of Currency,' which has two phases defined as follows:

First Phase—Fiduciary Currency

(*a*) All increases of Convertible Fiduciary Paper Currency, or of Fiduciary Paper Currency, will cause commodity prices to rise because an increase of demand will precede supply. Such increases will also extend the base of credit, which, if unregulated, will bring about an inflation of prices of securities, and this in turn will

bring about an increased demand for commodities, works of art, and luxury services, thus causing their prices to rise still further.

(*b*) If credit is contracted, and the quantity of currency remains the same, prices of securities will fall, but not commodity prices.

(*c*) If credit is expanded, and the quantity of currency remains the same, prices of securities only will rise.

(*d*) If credit is expanded, and the quantity of currency is contracted, it will not raise security prices. Both security and commodity prices will fall for reasons already explained. Security prices will fall because of the contraction of currency and trade activity, and the dearness of money.

(*e*) The rise in the prices of commodities and securities which an expansion of either a Convertible Fiduciary Paper Currency or a Fiduciary Paper Currency promotes is not based on the solid foundation of wealth. It is presumed to be. If the prices of commodities and securities are made to rise above their economic value they are inflated, and to the extent to which they are inflated to that extent do they debase currency £s. Experience has proved that every inflationary movement is the beginning of a deflationary movement, hence the reason why economists generally feel it to be essential that currency should be controlled and not credit. The limitation of currency is presumed to limit the expansion of credit. When currency is not covered by wealth there is a great deal to be said for this empirical method of controlling credit.

Second Phase—Standard Currency

(*f*) All increases of standard currency under the 'Dual System of Stabilisation' can have no effect on prices, because these are predetermined. The production of commodities has to take place before commercial credits

can be extended, in order to determine their eligibility. Prices are therefore predetermined and are based on the volume and cost of production, that is, on the cost of each unit produced. The break between currency and prices is thus complete. Prices follow the natural economic law and tend towards lowest cost, subject to profit.

(*g*) Circulating commercial credits can thus be extended indefinitely through currency, which cannot be inflated in view of (*f*), and because all expansions of currency must be covered by wealth.

(*h*) Expansions of standard currency will extend the base of financial credit, and unless the ratio were controlled inordinate expansions of credit would ensue, thus promoting an inflation of security prices. This defect is eliminated by limiting the ratio of credit expansion at 9 to 1, full power being given to the Central Bank to lower it should it be found desirable to contract financial credit. This obviates the present method of raising the Bank Rate, which experience has proved to be ineffective, and which unnecessarily penalises producers and consumers who are not responsible for the inflation of security prices.

Summary

Items (*a*) to (*e*) clearly demonstrate that when prices of commodities and securities are forced to rise, the currency becomes debased. The more so if it is of a fiduciary nature. Hence the reason why present monetary mechanism necessitates that currency should be controlled and not credit.

Items (*f*) to (*h*) promote the 'Dual System of Stabilisation,' hence the reason why credit must be controlled and not currency, which can be expanded to conform to the needs of the community. And all expansions of currency under this system will increase its purchasing power value, and not decrease it.

CHAPTER X

SHOULD THE £ BE DEVALUATED?

THERE are many economists, politicians, and industrialists who favour a permanent devaluation of the £ because they feel that by so doing they would be able to devalue Government and Municipal securities, and the annual interest charges payable thereon. But unfortunately it would have a similar effect on all other fixed interest securities, and on contractual obligations of an industrial and trading character. No consideration would seem to be given to the poor widows, and other innocent persons, whose resources are invested in British Government and Municipal securities, in order to ensure, as they believe, the safety of their capital.

It is not necessary to devalue a currency in order to devalue Government and Municipal indebtedness. If a currency were completely divorced from Government finance—as it would be if fully covered by eligible bills, since holders of currency notes would be entitled to claim the cover behind them—Governments would not be able to devalue their currencies in order to evade their internal and external obligations, as has happened in the case of France, Italy, and Germany. It is a cheap way of carrying on a war. Borrow, and then devalue the currency.

As Great Britain is a creditor nation, she certainly cannot afford to devalue her currency by 20 per cent., since it would mean a loss of at least £80,000,000 in her annual income receivable from her foreign investment and invisible services, which, capitalised on a 5 per cent. basis, would mean a capital loss of £1,600,000,000. I cannot say that these figures are accurate, but for

the purpose of the argument they may be taken as being approximately correct. If the £ declines further they may be accepted without question.

The total currency in circulation is approximately £400,000,000. To devalue this by 20 per cent. means a loss of £80,000,000 only. But why should this small loss cause losses aggregating thousands of millions in other directions? Why should a rise in the Bank Rate by 1 per cent. cause losses in directions not concerned with attracting short-term deposits and gold to London? To ask these questions is to reveal the absurdity of the monetary mechanism employed throughout the world to-day, with perhaps one or two exceptions.

Then, again, in devaluing the £ by 20 per cent. we are in effect deflating the currency, since we reduce the effective currency in circulation in terms of gold from £400,000,000 to £320,000,000. Contract the currency, and increase the volume of work it has to do, and prices will fall with a certainty. This form of deflation, however, will not increase the purchasing power of wages and income; on the contrary, it will have the effect of decreasing them. The nominal value of the £ may remain, but owing to its depreciation in terms of gold the purchasing power value will decline. If this is not corrected by an increase of the currency, it will prevent prices from rising in terms of gold. In other words, the positive movement will be offset by the negative movement, and this will enable the Treasury authorities to say that the depreciation of the £ has not induced a proportionate rise in internal prices. The public will not know the price it is paying for this illusion.

The fall in the value of the £ has been acclaimed in many sections of the Press, and in industrial circles, as a blessing. As a temporary expedient it will reduce wages, and it may assist industrialists to increase their competitive power temporarily, but they overlook

the vital fact that as they reduce internal purchasing power, so they reduce internal demand. As Lincoln said, ' We may fool the people some of the time, part of them all the time, but not all of them all the time.'

Soon there will come a time when a demand will be made by Labour for an increase of wages, to cope with the inevitable rise in prices that will ensue when tariffs are imposed. If the currency were to remain on a depreciated basis, more currency would be required to cope with the increase of business envisaged by those who believe tariffs to be the one and only cure. If both these demands were conceded, as they would have to be if the Government desire to remain loyal to their pledges, an inflation of currency and credit would take place, the end of which would not be difficult to foresee. Certain it is that the temporary advantage accruing to industrialists from the depreciated £ would soon disappear. More currency £s would be required with which to pay wages, and pay for the necessaries of life. When we arrive at this stage, what advantage will have been derived by the industrial and commercial community from a devaluation of the £ ? No attempt is being made here to justify the maintenance of the existing inelastic system. All that is being done is to demonstrate that an elastic system of currency is required, and that the parity of a currency should be made invariable, and not tampered with. Unless we can measure the worth of our labour and services with a definite degree of accuracy, we cannot begin to distribute economic justice, nor to measure the progress which humanity is making to this end.

Should the Bank of England and the Treasury, wisely in the circumstances, succeed in persuading the National Government not to inflate the currency, then the recent election need not have taken place. Beyond its policy of enforcing economy and increasing taxation, no other practical result can ensue. It may be able to propose

and enforce tariffs, but the country as a whole will not be able to derive any material benefit from these measures.

If my thesis be correct, it does, of course, raise the question whether these measures are in the long run necessary. As a temporary expedient I think they are, if only to fill in the gaps in our economic system, and enable us to face the World with a reality. If it be essential, as I think it is, that each nation should adopt a Central Reserve Standard with a view to uniformity and standardisation of Central Banking practice, it presupposes uniformity and standardisation in fiscal matters. We may have a long way to go before we can make the World as a whole realise this aspect of the question, and for this reason it will undoubtedly be desirable that we should proceed with the formation of an Empire Economic Unit.[1]

It is generally agreed that with the extreme fall that has taken place in World prices, the burden of discharging War Debt and the annual interest charges thereon, has become onerous. As I stated in my supplementary evidence to the Macmillan Committee, the proper way to have met this situation was to have converted the whole of the Internal National Debt to a 2¾ per cent. tax free basis. This would have placed the purchasing power value of the debt on a footing more in accord with the average purchasing power which prevailed at the times the bulk of the debt was created. This is the correct way to devalue credit £s without devaluating currency £s, should these constitute the measure of value in accordance with a Central Reserve Standard.

When I made this suggestion, the £ was anchored to its gold parity ; before the scheme could now be offered

[1] If our ultimate aim be to obtain 'peace on earth to men of good-will,' all nations must be able to obtain the primary products they may need ; this they will only be able to do through a full development of the barter system, such barter being confined to exportable surpluses.

to the holders of Government and Municipal securities, it would be necessary to guarantee that the £ would be restored to parity. Were any attempt made to restore the £ to parity without an agreement to convert Government and Municipal securities to the basis above mentioned, violent opposition would be raised by the whole of the industrial and commercial community.

With the £ standing at a discount of 20 per cent., the scheme is an attractive one to the holders of Government and Municipal securities. Let us take War Loan as an example. Its present market price is 100, but its gold value is 80. Assuming that a new $2\frac{3}{4}$ tax free gold loan were to be issued, and that each £100 of War Loan were to be taken over at 95, each holder of War Loan would improve his position, over his present one, by 15 points per every £100. Now let us see how it would affect the interest of 5 per cent. which each holder receives. Assuming the depreciation of the £ to be 20 per cent., the net yield in terms of gold would be 4 per cent. From this has to be deducted income-tax at 5*s*. in the £. A small holder would, of course, have allowances made, but a large holder would have to bear the full weight of the tax. But to retain the simplicity of the argument, let us assume that 5*s*. in the £ has to be deducted, we arrive at an amount equal to one-quarter of the income, namely, $1\frac{1}{4}$ per cent. Adding the two items together, that is, depreciation of the £ and income-tax, we find the present yield on interest receivable from War Loan to be $2\frac{3}{4}$, so that the scheme proposed inflicts no hardship from the point of view of income.

What the scheme does do, however, is to affect a saving of approximately £55,000,000 per annum in the interest charges payable on Government securities (after permanently removing income tax receivable thereon at 5*s*. in the £), and thus to reduce Government expenditure by this amount. And last but not least, by eliminating

all discounts which exist on most of the present issues of Government securities, the total nominal value of the National Debt would be reduced from £6,463,000,000 to £5,788,000,000, a saving of no less than £655,000,000.

In this way we reduce the onerous burden of Government and Municipal debts without imposing any hardship on holders of the securities, and without the need for devaluating the currency. On the contrary, as most of the holders will be taxpayers and ratepayers, the savings which the scheme envisages will, for the most part, come back to them in the form of a reduction in direct and indirect taxation.[1]

The final effect of the scheme would be therefore:

Internal.

(*a*) To reduce the nominal national debt by £655,000,000.[2]

(*b*) To reduce the interest charges payable on the debt by £55,000,000.

(*c*) To reduce Municipal rates.

External.

(*d*) To prevent £80,000,000 of the Nation's revenue being lost, which would be the case if the external value of the £ remained at 16*s*.

(*e*) To prevent a capital loss of £1,600,000,000 in our foreign investment quoted in £s, and in other items.

[1] In January of this year, through the good offices of the London Manager of the Commonwealth Bank of Australia, I sent the above scheme through the head office of the Bank to the Australian Government for consideration. The scheme was adopted and put into force. It has been a great success. I also submitted it in my evidence to the Committee on Finance and Industry, but it was ignored. The scheme is outlined in my book the *Dual System of Stabilisation*.

[2] Since this chapter was written the foreign exchange rate of the £ has fallen to 13*s*. 3*d*., and the price of War Loan has fallen to 93¾. I think it would be fair to all parties to suggest that Government and Municipal securities should be converted into 2¼ per cent. tax free gold loans at the market prices ruling on 21st December, 1931. On this basis a slight further saving on the internal figures would be shown.

CHAPTER XI

DEBTS AND THE BALANCE OF TRADE

WE have now to consider in what way the United States and France have acquired the power to drain London of its gold, particularly when we bear in mind that, as recently as 1926, the 'franc' was the most unstable of currencies. I have discussed the latter aspect of the question in the *Dual System of Stabilisation* (pp. 202–12). The change that has taken place in the character of the assets and liabilities of the Banque de France should be noted on pp. 204–5 of the same book.

In order that the aspect of the question to be discussed here may be more fully appreciated, it will be necessary to define what is meant by the balance of trade. I cannot do better than quote the excellent definition supplied by the United States Department of Commerce in its annual report, *The Balance of International Payments of the United States*, 1929. The following quotations are taken from the report (pp. 67–70):

The largest group of invisible items is, of course, new loans, investments, and deposits. Moreover, the yield of previous credit transactions is the largest invisible export. When it is seen that in absolute amounts commodity transactions constitute about half of the international turnover, one realises the extent to which commodity and credit transactions dominate our balance of payments. Small wonder that economists so often base themselves on a 'two-cylinder' balance of payments consisting of only these two large items.

A balance of payments is a tabulation of all known or estimated transactions between two areas which tend to influence the movement of gold or other accepted currency between the two areas during a given period.

In content, however, the itemised account so constructed would be much more than an analysis of the gold movement, as the following alternative definition shows :

A balance of international payments is a statement of the compiled or estimated amounts of all the invisible and visible exports and imports of a country during a given period, so arranged as to show their comparative size, their total (the international turnover), their influence upon the international gold movement, the 'detractive' and 'promotive' relationships between them, and the volume and character of the nation's foreign-exchange transactions.

There are only three visible items of American foreign trade—merchandise, silver, and gold. Many countries count silver as merchandise, and hence have only two visible items.

A balance of payments has been shown to be a survey of foreign-exchange transactions, an investigation of gold movements, a cashbook of dealings with foreigners, and an analysis of the financing of our foreign trade or of the effect of our foreign loans. At least two other view-points are useful : (1) Economists of the last century generally regard international trade as barter. In this light, a balance of payments becomes two lists of goods and services exchanged in barter. (2) In terms of the 'Law of Detractions and Promotions' a balance of payments itemises international transfers of purchasing power. The debt footing shows the extent to which the United States contributed to the purchasing power of the outside world ; the credit footing shows the extent to which our dealings with foreigners have increased our purchasing power.

The effect of tariffs (or of other restrictions of our international trade, travel, or loans)—whether imposed by Government or by a foreign government—can be analysed by this simple formula : Whatever tends to diminish an item in one column of the balance of payments tends to promote every other item in that column and to detract from every item in the other column.

It is often said that imports (visible and invisible) must be paid for with exports (visible and invisible). This is true of totals, but because of the detractive influences, it is untrue of an individual item. One item of import may be increased by importing less of something else. To detract is to substitute. All credit items in the balance of payments are rival commodities (like radios and phonographs in domestic trade), and so are all debt items. Again, the credit items, as a group, create what economists call a 'composite demand' for the debt items ; and vice versa.

Our immediate concern is with the conclusions 'that the yield of previous credit transactions is the largest invisible export,' that 'a balance of payments is a tabulation of all known or estimated transactions between two areas which tend to influence the movement of gold, etc.,' and that in terms of the 'Law of Detractions and Promotions' a balance of payments itemises international transfers of purchasing power.

With what success has the United States practised this policy? Prior to 1914 the United States was a debtor nation on balance to the extent of £500,000,000, but as a consequence of the War, and the institution of the Federal Reserve System, December 1913, she is now a creditor nation to the extent of £4,600,000,000.

To meet the interest charges on her external debt prior to 1914 the United States had to have a surplus of exports over imports as indicated in Table 1, page 67.

As a creditor nation the United States drew a record income in 1930 from her foreign investment of no less than $1,380,278,000, yet it will be seen that her actual exports of merchandise for that year still exceeded her imports by no less than $782,000,000, and that the total of these two sets of figures amounts to $2,162,278,000, which taken at $5 to the £ equals £432,455,600. From this sum has to be deducted various sums to cover the cost of certain invisible imports such as expenditures by American tourists abroad, freight charges, and interest payable on foreign funds invested in the United States, etc.

After making all requisite adjustments the United States increased her investment abroad by $733,000,000 and imported gold to the value of $278,000,000, a sum which is more than half the value of the gold produced in the year throughout the World.

From the table of figures shown on the next page it will be seen that the United States has been a consistent im-

TABLE I.—EXPORTS, IMPORTS, AND BALANCE OF TRADE OF THE UNITED STATES

[Value in millions of dollars; data cover years ended 30th June through 1915; thereafter calendar years.]

Yearly Average or Year.	Merchandise.					Excess of Exports (+) or Imports (−).			
	Exports.								
	Total.	United States Merchandise.	Re-exports of Foreign Merchandise.	General Imports.	Ratio of Imports to Total Trade, per cent.	Merchandise.	Gold.	Silver.	Merchandise, Gold, and Silver.
1876–1880	677	664	13	493	42·1	+ 184	− 12	+ 9	+ 182
1881–1885	792	775	17	667	45·1	+ 125	− 21	+ 11	+ 114
1886–1890	738	726	13	717	49·3	+ 21	+ 3	+ 13	+ 38
1891–1895	892	876	16	785	46·8	+ 107	+ 38	+ 20	+ 165
1896–1900	1,157	1,136	21	742	39·1	+ 416	− 24	+ 27	+ 419
1901–1905	1,454	1,427	27	972	40·1	+ 482	+ 1	+ 23	+ 506
1906–1910	1,779	1,751	28	1,345	43·1	+ 434	− 15	+ 14	+ 433
1910–1914	2,166	2,130	35	1,689	43·8	+ 477	+ 17	+ 20	+ 515
1913[1] .	2,484	2,448	36	1,793	41·9	+ 691	+ 28	+ 27	+ 746
1911–1915	2,371	2,332	39	1,712	41·9	+ 658	− 3	+ 23	+ 678
1915–1920[2]	6,521	6,417	105	3,358	34·0	+ 3,163	− 149	+ 79	+ 3,093
1921–1925	4,397	4,310	87	3,450	44·0	+ 947	− 265	+ 10	+ 692
1926–1930	4,777	4,688	89	4,034	45·8	+ 744	− 33	+ 19	+ 729
1921	4,485	4,379	106	2,509	35·9	+ 1,976	− 667	− 12	+ 1,297
1922	3,832	3,765	67	3,113	44·8	+ 719	− 238	− 8	+ 473
1923	4,167	4,091	77	3,792	47·6	+ 375	− 294	− 2	+ 79
1924	4,591	4,498	93	3,610	44·0	+ 981	− 258	+ 36	+ 759
1925	4,910	4,819	91	4,227	46·3	+ 683	+ 134	+ 35	+ 852
1926	4,809	4,712	97	4,431	48·0	+ 378	− 98	+ 23	+ 303
1927	4,865	4,759	107	4,185	46·2	+ 681	− 6	+ 21	+ 695
1928	5,128	5,030	98	4,091	44·4	+ 1,037	+ 392	+ 19	+ 1,448
1929	5,241	5,157	84	4,400	45·6	+ 841	− 175	+ 19	+ 686
1930	3,843	3,782	62	3,061	44·3	+ 782	− 280	+ 11	+ 514

[1] Calendar year. [2] Period 1st July, 1915, to 31st December, 1920.

porter of gold since the close of the War. She has looked upon gold as a commodity subject to the 'Law of Detractions and Promotions' notwithstanding anything the Department of Commerce may assert to the contrary.

America is endeavouring to become a great financial centre, and so is France. They are both attempting to

assume the position which Great Britain occupied before the War as the World's financial centre. But what both the United States and France forget is that Great Britain allowed her creditors to pay in commodities and services by maintaining free trade at her ports. Whether this was desirable from the point of view of her internal productive power, or Empire trade, is immaterial to the argument now under discussion—I have shown that it was not—but what is relevant is that Great Britain never lost sight of the fact that it was bad business to impoverish her creditors. She has, in fact, in the post-war period carried this doctrine to a foolish extent. She did not recognise sufficiently clearly that with the advent of the War, and the piling up of National Debts, the World was no longer what it was and that her own position had changed materially since 1914. She acted like the person who was loth to leave an old house because he had occupied it so long.

In saying what I have said it is not to be understood that I am in any way questioning the 'Law of Detractions and Promotions' as developed by the Department of Commerce. I agree 'that whatever tends to diminish an item in one column of the balance of payments tends to promote every other item in that column and to detract from every item in the other column.' But I respectfully suggest that this should not apply to gold. It is not necessary. To permit an attack to be set up against the gold reserves of Central Banks is foolish business, since these are essential to buttress all other monetary systems, the maintenance of the strength of which is essential if the United States wishes to see her foreign investments retain their value and be repaid at their due date. The 'Law of Detractions and Promotions' not only applies to internal trade mechanism but to external as well. It will certainly operate forcibly against the foreign investments of the United States, as

she is now learning to her cost. No more juice can be squeezed out of a lemon than there is in it.

The United States has attained its present favourable position as a consequence of the War. During the War period the belligerent countries had to borrow in order to pay for the excess of imports from the United States. This expedient was resorted to because of the inability to pay the difference in gold or in exports. But the policy resorted to then is not one that can be continued indefinitely. The gold reserves of a Central Bank were never intended to be used for the settlement of debts, but only for the settlement of trade balances. The growth of debts occasioned by the War should have ensured a more rigid adherence to this policy. The magnitude of the debts created should have induced careful nursing of their debtors by creditor nations.

But the world in general must be indebted to France, the United States, and the City of London, for having forced the crisis. It has brought home a realisation of the fact that gold cannot serve as a currency either for national or international purposes. It can only serve as a unit of measurement. It is the promises to pay in gold, or in terms of gold, that induce the creation of debts. Nations can only promise to pay in terms of commodities and services, and if they were each to adopt a Central Reserve Standard, they would not need to borrow as freely as they have done in the past. They could create their own short-term money by developing their own production. If we take the whole of the bank credit created throughout the World to-day, at least 80 per cent. is absorbed by financial credits. A shocking state of affairs.

In my book, *The Flaw in the Economic System*, published in 1928, I wrote 'that the time would come when gold could be done away with altogether from monetary systems as currency or as the basis of credit ; that merchandise, gold, and produce could be bought and sold

on this basis; that it might point to the need of establishing an International Clearing House for the settlement of trade balances as between Nations; and that quarterly accounts should be aimed at in order to keep a check on the general position.' If it has been found essential to establish a clearing house for the adjustment of internal exchange transactions, it is surely as essential to establish one for the adjustment of international exchange transactions. Settlements could take place between Central Banks once every six months. Surplus balances could be bartered. If the Bank for International Settlements were employed for this purpose, its power should be extremely limited, and should not exceed what may be necessary to enable it to act as a clearing house. No action of the Bank should in any way interfere with the national independence of any country.

A good creditor Nation should not begin to collect its debts from debtor Nations if it means forcing their Central Banks to liquidate their gold reserves. Payment in gold should only be accepted as a temporary expedient. A good creditor Nation should be prepared to carry its debtors until it can be paid in commodities and services. To destroy a debtor country's monetary system by drawing off its gold reserves in satisfaction of debts is not good business. It compels the debtor country to contract its credit structure and trade activity, thus reducing its ability not only to discharge its external obligations in commodities and services but also its power to import. International trade is thus curtailed.

No creditor country should lend if it is not prepared to accept payment in goods and services from its debtors at the par value of their currencies. To allow debtor countries to discharge their debts in terms of gold whilst their currencies are depreciated, whatever the extent of the depreciation may be, is the height of folly. Stabilisation of exchange rates is the essential need of the future,

both for debtors and creditors. Until credit is controlled, and not currency, this will not be possible.

The fact that import duties are maintained by a creditor country should be no bar to it accepting commodities and services in satisfaction of its claims, so long as these are based on an elastic system of currency. Purchasing power will then be maintained at its highest point. The existence of import duties should merely enable the creditor country to select the imports in which it is prepared to accept payment.

According to the Law of Detractions and Promotions an export of a commodity tends to raise the rate of exchange in favour of the exporting country, and to lower it against the importing country, thus tending to detract from all other exports and to promote all imports. But with the existence of gold as an international currency, and the existence of the foreign exchange markets, it does not always follow that the country receiving the imports will be able to pay for them by exports, since the short-term credits created by the imports can be transferred through the foreign exchanges to other countries, where they may be more usefully employed.

For instance, if the United States sold us 5,000 dollars worth of motor-cars, she need not necessarily import merchandise from us in discharge of our debt to her. It is open to the United States, through the foreign exchanges, to arbitrage £s into rupees and with these to import tea from India and Ceylon. The rule can apply to any other primary product which the United States may choose to import from countries in the tropical zones. The advantage of tariffs, whilst gold is maintained as an international currency, is, that it enables a country like the United States to choose the kind of imports that will benefit her most. Should her imports from the tropical zones not be sufficient to discharge her total claims for the year, she must then lend the balance and/or import gold ;

TABLE 6.—UNITED STATES SHARE IN THE EXPORTS AND IMPORTS OF LEADING COUNTRIES (STATISTICS OF FOREIGN COUNTRIES)

NOTE.—Values in millions and tenths of millions of dollars. Data for each country cover calendar years, exept for Canada, which is the fiscal year ended March 31 following the year stated; for Australia, which is the fiscal year ended June 30, except for 1913; and for U.S.S.R. (Russia), which is the fiscal year ended September 30. Leaders indicate no comparable data or data not yet available.

Country.	Exports to the United States.						Imports from the United States.					
	Value.		Per cent. of Total Exports.				Value.		Per cent. of Total Imports.			
	1928.	1929.	1913.	1928.	1929.	1930 (Jan.–Sept.).	1928.	1929.	1913.	1928.	1929.	1930 (Jan.–Sept.).
NORTH AMERICA												
Canada	499·6	515·0	37·9	36·6	46·0	44·7 [1]	868·0	847·4	64·0	68·6	67·9	64·8 [1]
Cuba	202·5	208·8	80·0	72·8	76·6	....	129·3	127·1	53·7	60·8	58·8	....
Mexico	194·4	172·8	77·2 [2]	68·2	60·7	....	116·3	127·5	50·6 [2]	67·5	69·1	....
SOUTH AMERICA												
Argentina	84·2	89·0	4·7	8·3	9·8	....	187·4	216·1	14·7	23·2	26·4	....
Brazil	216·0	192·5	32·2	45·4	42·2	39·0	117·5	125·6	15·7	26·6	30·1	24·2
Chile	81·0	83·0	21·3	34·0	30·1	25·4	44·8	65·5	16·7	30·7	33·9	33·2
Colombia	101·4	....	44·5	77·7	....	....	64·7	....	26·7	44·6	....	....
Peru	35·6	44·6	33·2	28·5	33·3	....	28·7	31·1	28·8	41·1	42·5	....
Venezuela	32·6	42·3	28·7	27·8	28·2	....	46·1	48·2	38·5	57·4	55·1	....

EUROPE												
Belgium	67·3	66·0	2·9	7·8	7·4	5·3	86·1	93·8	9·0	9·7	9·5	10·2
Czechoslovakia	34·6	43·5	......	5·5	7·2	6·0	34·0	32·1	......	6·0	5·4	5·1
Denmark	3·2	5·0	1·1	·7	1·1	·6	60·9	64·1	10·2	13·1	13·3	11·5
France	130·8	130·2	6·1	6·5	6·6	5·7 [3]	243·5	281·4	10·7	11·6	12·3	11·5 [3]
Germany	189·9	236·0	7·1	6·5	7·4	5·9	483·5	425·7	15·9	14·5	13·3	12·3
Italy	80·1	90·2	10·7	10·5	11·5	11·2	211·2	187·3	14·3	18·3	16·7	15·7
Netherlands	27·7	28·5	......	3·5	3·6	2·9	106·8	109·4	......	9·9	9·9	8·7
Norway	17·5	19·6	7·7	9·6	9·8	....	32·5	30·0	7·1	11·8	10·5	....
Poland	2·1	3·5	......	·8	1·1	1·0	52·4	43·0	......	13·9	12·3	12·3
Sweden	44·5	53·2	4·2	10·5	10·9	....	67·5	70·1	9·0	14·7	14·8	....
Switzerland	37·7	40·0	9·9	9·2	10·0	8·4	47·1	46·2	6·3	9·2	9·0	8·2
U.S.S.R. (Russia)	13·9	19·8	......	3·5	4·4	4·3	96·7	78·8	......	19·9	18·3	27·6
United Kingdom	227·1	221·8	5·6	6·4	6·2	5·0	917·1	952·1	18·4	15·8	16·0	14·3
ASIA												
British India	140·6	139·8	8·9	11·7	12·0	10·0	61·5	59·9	2·5	6·8	6·7	7·7
British Malaya	198·9	220·2	13·7	41·5	42·4	40·0	16·6	18·4	1·8	3·3	3·6	3·4
Ceylon	25·5	26·6	16·6	18·5	19·4	....	5·5	4·9	1·3	3·8	3·3	....
China	90·3	111·3	9·3	12·8	17·1	....	145·9	147·7	6·0	17·0	18·0	....
Japan	383·4	421·4	29·2	41·9	42·5	34·4 [3]	290·3	301·5	16·8	28·5	......	28·7 [3]
Netherlands East Indies	80·9	....	2·2	12·8	......	....	38·7	....	2·1	9·9	29·5	....
Philippine Islands	115·6	124·5	34·7	74·5	74·5	79·9	83·9	92·6	51·2	62·3	62·9	63·3
OCEANIA AND AFRICA												
Australia	42·9	26·9	3·5	6·3	3·9	3·4 [3]	170·6	171·8	13·7	23·7	24·6	....
New Zealand	19·7	17·8	4·0	7·4	6·6	5·3	39·9	45·4	9·5	18·0	19·1	....
Egypt	30·5	36·8	7·9	10·9	14·2	8·0	13·4	14·0	1·9	5·2	5·0	....
Union of South Africa	7·7	8·0	·8	2·2	2·0	....	62·3	72·6	9·5	17·0	18·9	....

[1] Calendar year. [2] Year ended 30th June. [3] January-November 1930.

alternatively, she may leave her balances with foreign countries in the form of short-term deposits, to be drawn off at a future time in the manner prescribed. But this power to draw off short-term deposits is a menace, and was one of the reasons why Great Britain had to abandon the gold standard. This, of course, is in accordance with the Law of Detractions and Promotions, but it must impoverish Great Britain and those other countries who do not understand how to play the gold standard game.

A study of Table 6, pp. 72–3, vide *Foreign Trade of the United States*, 1929, will confirm the point of view here developed.

It is to be observed that the United States exports more to Great Britain, Canada, Australia, New Zealand, and South Africa than she takes from them, and that she exports less to India, Egypt, Malaya, and Japan than she takes from them. For example, the United States exported to Great Britain 952·1 million dollars of merchandise in 1929, and only imported 221·8 million dollars. Similar results are shown in the case of the Dominions. But to British India and Malaya she exports only 59·9 and 18·4 million dollars respectively, and imports 139·8 and 220·2 million dollars respectively. Such an excellent business arrangement was only possible because Great Britain, as one of the countries concerned, maintained free trade at her ports, and was willing to suit the needs of the United States by allowing the credits created by imports to be converted into foreign currencies in terms of gold. Great Britain also conveniently obliged by accepting imports from Germany in settlement of reparations and other debts, and also by creating short-term credits in favour of Germany through long- and short-term loans. Needless to say, France has likewise largely benefited from this policy.

There is only one way by which this policy may be

counteracted, and that is for Great Britain to employ the same economic and currency mechanism employed by the United States and France, and upon the new basis to build an Empire Economic Unit. The figures in the foregoing table reveal the tremendous potential strength that would accrue to her if she would do so, and in this matter she can act without the aid of an international conference. London can no longer be the financial market of the World, but it could be made the financial market of the Empire, a task great enough to restore its prestige and authority.

CHAPTER XII

AMENDMENTS NECESSARY TO CONVERT BANK OF ENGLAND TO A CENTRAL RESERVE STANDARD

In order to convert the Bank of England to the Central Reserve Standard required, I have suggested in my book, *The Dual System of Stabilisation*, the following amendments to the Bank Act of 1844, which would remove all the defects known to exist within the Federal Reserve System and other similar institutions; and I am suggesting the incorporation of the main amendments in the Central Reserve Systems already proposed for India and China, to which reference is made later.

The necessary legislation to be enacted in order to convert the Bank of England into a Central Reserve Bank should contain the following provisions. I am indebted to E. A. Goldenweiser's book, *Federal Reserve System in Operation*, for some of the information used:

(*a*) The title of the Act should conform to the full title of the Federal Reserve Act approved 23rd December, 1913, which reads as follows:

> An Act to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of re-discounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

According to E. A. Goldenweiser, 'this title indicates that next to the creation of elastic currency the framers of the Act considered "that to afford means of re-discounting commercial paper" was the most important purpose of the Act.'

(*b*) The provisions of the Federal Reserve Act

'indicate the fundamental nature of the discount activity of Federal Reserve Banks. These discounts must originate in a demand in the commercial market for purposes of production and distribution. *The Reserve Banks thus are intended to create only circulating credit*, and not credit to be used for capital purposes or for speculation. The liquid nature of the discounts is further assured by the requirement that the paper must mature within ninety days' (Goldenweiser). The italics are mine.

(*c*) A member bank may be permitted to extend credit by way of discount to a trader for the purpose of carrying merchandise in store, the disposal of which may take six to nine months, but it shall be re-discountable at the Central Bank any time during the last three months of its maturity. This means that the member bank would have to carry the discount in its own portfolio during the first three or six months, whichever the case may be.

(*d*) With regard to discounts for purely agricultural purposes, as agricultural turnover is much slower than industrial turnover, the date of maturity of eligible bills should be extended to six or nine months at the discretion of the member banks from the usual ninety days. No limit to be placed on the amount of bills discountable provided their maturity date does not exceed six months. But in the case of bills having a maturity date in excess of six months, the amount discounted should not exceed 15 per cent. of the total assets of the Bank. Agricultural paper having a maturity date of nine months offers no greater facilities to agriculture than three months' paper offers to commerce and industry. Agricultural paper, within the meaning of Section VI, Federal Reserve Act, is defined as 'a negotiable note, draft, or bill of exchange issued and drawn, or the proceeds of which have been or are to be used for agricultural purposes, including the production of agricultural products, the marketing of agricultural products by the growers thereof, of the

carrying of agricultural products by the growers thereof pending orderly marketing, and the breeding, fattening, or marketing of livestock, and which has a maturity at the time of discount of not more than nine months, exclusive of days of grace.

(*e*) All the joint stock banks and private banks which accept deposits and make advances should be obliged to become members of the Central Reserve Bank and submit to the regulations of the Central Reserve Act.

(*f*) Provision should be made to prohibit the Central Reserve Bank from trading for profit, and dividends should be limited to 6 per cent. It should in no way compete with the member banks. The capital of the Bank should be subscribed as to 50 per cent. by the member banks and 50 per cent. by the general public.

(*g*) The Chairman and two other directors of the Bank should be appointed by the Government, and the remaining six directors by the members of the Bank, three of whom should represent commerce and industry and three representing banking. Branches of the Bank should be established at Manchester, Glasgow, and Belfast.

(*h*) The Central Reserve Act should provide, *inter alia*, that the ratio of deposits to cash held, in hand and at the Central Reserve Bank, by the member banks should not exceed 9 to 1, and that the Central Reserve Bank should have power to reduce this ratio by ½ per cent. at a time in order to promote stability, or to check undue speculation. (In the case of India and China the ratio should be 7 to 1.) The Central Reserve Bank should be prohibited from manipulating the re-discount rate for the purpose of checking speculation in the financial system of banking, which, as experience has shown, is ineffective.

(*i*) The Central Reserve Bank should be prohibited from purchasing securities or bills for its own account, except, perhaps, for the investment of its own reserves.

A preferable course might be for the Bank to invest its reserves in foreign currencies, or short-dated dollar and franc securities which could be converted into gold on demand.

(*j*) With regard to the securities held by the Bank of England at the present time against the fiduciary issue, these should be sold gradually, as and when favourable opportunities occur, until they are reduced to a sum not exceeding £20,000,000. The securities sold should be replaced by eligible re-discounts.

(*k*) It should be compulsory on all member banks to re-discount all eligible commercial bills with the Central Bank.

(*l*) The gold reserves to be held by the Central Reserve Bank against its currency notes in circulation, and against the deposits of its member banks, should be approximately £175,000,000. In the event of the reserves falling below this sum, on no account should re-discounting be discontinued. Should the authorities find a contraction of credit to be desirable, they should begin by contracting the bankers' ratio as provided for in item (*h*).

(*m*) The Central Reserve Bank should not be permitted to lend money to member banks against securities, Government or otherwise. It should strictly confine itself to re-discounting eligible commercial bills and ensuring the convertibility of the currency. In this connection, it will be of interest if I add the following by E. A. Goldenweiser, with which I agree :

In every Reserve Bank there is a loan committee, consisting of some of the higher officers, which passes upon each piece of paper presented to the bank for discount. This committee must first ascertain whether the paper is eligible under the law and regulations of the Federal Reserve Board, and second, whether it is acceptable, *i.e.* whether the credit back of it is good ; whether the particular member bank which presents it is entitled to more credit, etc. This distinction between eligibility and acceptability

of paper presented for discount to the Federal Reserve Bank is important and is not always appreciated.

Eligibility is a matter of law and regulation. In order to be eligible paper must comply with definite standards as to the transactions which gave it origin and as to maturity, while its acceptability is entirely independent of these matters and rests on the credit standing of the signers, the availability of funds, the question of whether the particular member bank has exhausted its legitimate quota of credit, whether experience has shown that the Bank is using Federal Reserve Bank accommodation for improper or undesirable purposes, and a number of other considerations which are not definitely formulated but are entirely within the discretion of each loan committee and board of directors, subject to the legal limitation that the Federal Reserve Bank shall grant accommodation to each member bank with due regard to the rights of other member banks and with a view to 'accommodating commerce and industry.'

Note to Chapter XII

Since the completion of this book I have received from the Federal Reserve Board, Washington, a copy of the *Report of the Committee on Bank Reserves of the Federal System*, and as this committee, broadly speaking, accepts the principle of the control by the Federal Reserve Banks of the ratio at which member banks may expand credit, I have deemed it desirable to include here the main recommendation made by the committee and some of their reasons for making it, particularly in view of the fact that the report is not accessible to all students of the subject under discussion. It is impossible to include the whole of the report. I am naturally glad to receive such early confirmation of this essential part of my thesis.

'In the opinion of the committee, our present system of legal requirements for member bank reserves has never functioned effectively since its inception in 1914. It has not operated to relate the expansion of member bank credit to the needs of trade and industry, nor has it adequately reflected changes in the volume and activity of member bank credit. Furthermore, the committee also finds that present requirements for reserves are inequitable and unfair as between individual member banks and groups of member banks and do not adequately take into account genuine differences in the character of banking in which a member bank may be engaged.

'The committee takes the position that it is no longer the primary function of the legal reserve requirements to assure or preserve the liquidity of the individual member bank. The maintenance of liquidity is necessarily the responsibility of bank management and is achieved by the individual bank when an adequate proportion of its portfolio consists of assets that can be readily converted into cash. Since the establishment of the Federal Reserve System, the liquidity of an individual bank is more adequately safeguarded by the presence of the Federal Reserve Banks, which were organized for the purpose, among others, of increasing the liquidity of member banks by providing for the re-discount of their eligible paper, than by the possession of legal reserves.

'Before deciding to recommend fundamental changes looking toward the establishment of a new basis for calculating required reserves, the committee made every effort to frame provisions designed to correct the existing situation through modifications in the classification of cities for reserve purposes and in the classification of deposits subject to reserve, including a more stringent definition of time deposits. As these proposals were studied, however, it became more and more evident that they would not be effective and that an entirely new approach to the reserve problem was necessary.

'The committee proposes, consequently, to abolish completely the classification of deposits into time and demand deposits, and the classification of member banks according to their location, into central reserve city banks, reserve city banks, and country banks. Instead, the committee recommends that all member banks and all deposits be treated alike for reserve purposes, and that the formula used in calculating reserve requirements take into account directly, instead of indirectly as in the existing law, the activity as well as the volume of the deposits held by each individual member bank, without regard to the location of the bank or the terms of withdrawal on which the deposits are technically held. To accomplish this, the committee proposes that each member bank be required to hold a reserve equivalent to (*a*) 5 per cent. of its total net deposits, plus (*b*) 50 per cent. of the average daily withdrawals actually made from all of its deposit accounts. These withdrawals, which are shown by debit entries on the books of member banks, are the only real test of the activity of a deposit account and furnish the only basis by which that activity can be equitably and effectively reflected in requirements for reserves. Under this proposal, therefore, each deposit will carry a total reserve based on its activity as well as on its amount. A totally inactive deposit will carry a total reserve of only 5 per cent., while a deposit balance which is checked out on the average once a week will carry a total reserve equivalent to 12 per cent. of its amount. For the average member bank the total reserve under the proposed formula will be equivalent to about 8 per cent. of its deposits. To prevent this formula from imposing too great burden in extreme cases, the recommendations of the committee also provide that in no case shall the aggregate reserve required of a bank exceed 15 per cent. of its gross deposits.

'The committee feels that the existing volume of reserves is sufficient at the present time to provide the reserve banks with the

funds they require to perform their functions. Its proposals, consequently, do not contemplate a change in the total amount of reserves. They are intended rather to change the nature of fluctuations in the volume of reserves and to iron out inequitable features in their distribution among the member banks.

'The most important function served by member bank reserve requirements is the control of credit. This function has a bearing on the liquidity of bank credit, for, in the nature of things, bank credit is most liquid when credit conditions are sound, and unsound credit conditions do not usually develop unless the banking community in general has expanded its credit beyond the needs of trade and industry. The over-expansion of credit may take a particular form, such as excessive loans on farm lands, on urban real estate, or on securities, or it may be more general applying to a wide range of bankable assets. Whatever its form, it has the effect of temporarily inflating the general purchasing power of the community and also of raising for a time the market value of bank assets beyond their intrinsic worth. It is the function of reserve requirements to restrain such over-expansion by making it necessary for banks to provide for additional reserves before they expand their credit.

'The American public has widespread banking facilities and is thoroughly educated in the use of checks. Their demand for pocket currency, consequently, is relatively small since its use is limited largely to transactions in which currency is the only convenient method of payment. In recent years there has also taken place a rapid increase in the use of checks for wage payments which has materially reduced the demand for cash for industrial pay rolls. While this substitution of checks for currency may reflect a socially desirable development, it does not constitute a logical or valid reason for a reduction in the reserve requirements of member banks since the effect upon business activity and upon the position of the individual member bank is the same whether a depositor's account is drawn upon to make payments by check or by currency.

'Unsound credit developments arise usually during periods of prosperity when the public is optimistic and both bankers and borrowers are likely to over-estimate the value of collateral which is offered to banks as a basis for loans. Such conditions are reflected usually both by an increased demand for bank credit and by increased activity in the deposit balances of those individuals or corporations which deal in the commodities, securities, or services that are requiring a speculative value.

'In the boom, which ended in 1929, on the other hand, the greatest increases in deposit activity occurred in New York City and other large eastern cities, where speculation in common stocks was most active.

'No formula for determining member bank reserves can prevent these speculative situations from recurring, but the proposed formula will operate to check their growth and help to bring them under control. It will increase requirements for reserves sharply at those individual member banks whose customers are at the centre of an incipient speculative movement, and so set in motion forces of a restraining nature at the focal point of disturbance. These forces will probably take different forms. Bankers whose requirements for reserves increase sharply as a result of these activities will find their lending power reduced somewhat and so will be less inclined to finance speculative developments.

'The committee believes that the proposed system of reserve requirements is not only sound in principle, equitable as between the member banks, and constructive in its influence on credit conditions, but that it is also simple to administer and not susceptible of abuses such as those which have grown up around the existing provisions granting a low reserve for time deposits. The committee has canvassed the administrative difficulties which may arise under the proposed system and also the possibility that once introduced it will not operate in the manner expected.'

The two vital paragraphs in the proposed amendment to section 19 of the Federal Reserve Act, as recommended by the Committee, are as follows:

'(*a*) Each member bank shall establish and maintain reserves equal to 5 per centum of the amount of its net deposits, plus 50 per centum of the amount of its average daily debits to deposit accounts; but in no event shall the aggregate reserves required to be maintained by any member bank exceed 15 per centum of its gross deposits.'

'(*j*) The Federal Reserve Board is authorized and empowered to prescribe regulations defining further the various terms used in this act, fixing periods over which reserve requirements and actual reserves may be averaged, determining the methods by which reserve requirements and actual reserves shall be computed, and prescribing penalties for deficiencies in reserves. Such regulations and all other regulations of the Federal Reserve Board shall have

the force and effect of law and the courts shall take judicial notice of them.'

The next reform which the Federal Reserve Board should recommend, in order to make the Dual System of Stabilisation effective in the United States, is that all non-member banks should become members of the Federal Reserve System, and that they should be formed into larger units with a view to the development of branch banking on lines similar to those prevailing in this country. It is now clear that if the ' Dual System ' were adopted by Great Britain she would be in a position to co-operate effectively with the United States and France in the development of a World Monetary Policy.

CHAPTER XIII

THE SILVER PROBLEM

The regulations developed in the preceding chapters can apply equally to silver-using countries, such as India and China. I have already shown that no metallic medium can function efficiently in a dual capacity as the 'standard' and 'measure.' Before the monetary difficulties in India and China can be solved, the authorities must make up their minds to discard the use of silver as legal tender currency in any form.

Nevertheless, we have a silver problem to solve. We have induced the people of India and China to look upon silver as a 'standard' and 'measure,' and to exchange their wealth for the metal. Hoards have been accumulated, and it is but right and proper that this position should be liquidated, since the people of India and China have been involved in heavy losses, which have resulted in a considerable diminution of their purchasing power, with prejudicial effects on World trade. Apart from the heavy losses which the people of India and China have suffered directly from the fall in the value of silver as a commodity, and from the actual contraction of currency in India, the heavy fall which has taken place in the value of silver has practically been equivalent to a severe contraction of currency, and this has contributed very largely to the deflation of World prices. (See also pp. 6 and 40.)

When bi-metallists suggest that the price of silver should be trebled or quadrupled, and stabilised at its increased level, they simply ask that the volume of currency should be increased without cover. This equals inflation. We know that inflation will raise prices, and

this seems to be the chief merit of the bi-metallic theory. Furthermore, if it be the wish of bi-metallists that silver as currency should be employed as 'a measure,' do we need to use such an expensive material as silver? The most effective measure is that which is the least expensive, *i.e* paper, provided the public have confidence in the fact that it also actually represents wealth at face value.

In order that we may the more truly appreciate the silver problem that has to be solved, we must first of all ascertain what has brought about the fall in the value of silver. Bi-metallists would seem to treat this aspect of the question light-heartedly. They simply contend that as the price of silver has fallen it should be put back again; and that to prevent it falling again it should be anchored to gold at a fixed ratio—say, of 4*s*. per ounce. Some bi-metallists advocate a lower price, but it is immaterial to the argument what the agreed price may be. The increased price of silver would no doubt raise the prices of other commodities and services in China, but it would not do so equally in other parts of the world, unless each nation had precisely the same percentage of gold and silver, and agreed to maintain it against all difficulties. But I am afraid Gresham's Law would operate here—bad metal would drive out good metal. In my opinion the bi-metallic theory is based on false logic.

The fall in the value of silver is due, like the fall in the value of all other commodities, to a universal contraction of currency. The only exceptions are France and the United States. I think I have proved this point beyond any possibility of doubt, and, if it be accepted, the problem is reduced to a simple issue. The value of the whole of the hoards of silver in India and China are determined from day to day by the price which new silver will fetch on the market. Was there ever a more nonsensical policy? A small piece of silver, so to speak, is thrown into the

centre of the pond, and the ripples extend to the outward edges. The tail wags the dog. Quite clearly what we have to do is to introduce a new invariable currency to the East, whose measure of value is not dependent on any one commodity.

Chinese expert opinion favours the stabilisation of silver as a commodity at a price in the vicinity of 16 pence, if a Central Reserve Standard is not obtainable. But whilst this would still confine the use of silver as legal tender currency to China, it would, nevertheless, require a World agreement to stabilise it in relation to gold. And as many countries have been forced to abandon gold, there is not much hope of this proposal fructifying in the near future. In any event, stabilisation would mean perpetuating silver as legal tender currency in China and other silver-using countries.

There is only one course that the World Powers could take, and that would be to agree to increase the use of silver in all their appropriate token coins, and to restore its use in cases where it had been abandoned. By increasing the demand in this way, they could help India and China to liquidate its hoards gradually, in the manner hereinafter prescribed.

The real solution of the problem is that the Governments of India and China should first of all agree to adopt Central Banking on the lines discussed herein. A bill has already been put forward by the Government of India to establish a Central Reserve Bank, based on the report of the Royal Commission on Indian Finance and Currency. The following extracts from the report will be of interest.

(Para. 111.) It has already been indicated, in general terms, that it is one of the primary functions of the Reserve Bank to act as the Banker of the Government and to hold its cash balances. The centralisation in its hands of these balances and of the banking reserves in India of all banks operating in India is an indispensable

condition for the proper discharge of the Reserve Bank's primary duty of controlling credit and consequently the volume of the monetary circulation. It is no less indispensable that all the remittance transactions of the Government should be entrusted to it, as recommended in the preceding paragraphs, and that any balances of the Government of India and of the Secretary of State outside India should be placed in the charge of the Reserve Bank, through its branches or agencies. Only then will any danger of the Government's remittance policy interfering with the proper management of the currency be eliminated. We recognise that this recommendation involves the amendment of section 23 of the Government of India Act. We recommend that such an amendment should be made.

(Para. 114.) The goal of all monetary policy is the achievement of stability of the purchasing power of the monetary unit, and the condition under which the sole right of note issue is entrusted to the Bank must clearly be the obligation to maintain stable the purchasing power of the rupee, both internally and externally. This stability will find expression internally in the stability of the general level of commodity prices, and externally in the stability of the purchasing power of the monetary unit in relation to gold, and consequently in relation to all exchanges with countries whose currencies are linked to gold through either a gold or a gold exchange standard. To assure this stability, it is indispensable that the obligation should be put upon the Bank at all times to buy and sell gold at fixed prices which are laid down in the charter. The question as to what these prices should be will be discussed later on.

(Para. 116.) 'It is evident that a limitation of the monetary circulation to the real needs of the country postulates contraction and expansion of the currency in accordance with those needs. In a mainly agricultural country like India those needs fluctuate widely, not merely in accordance to the seasons of the year, but also according to the abundance or otherwise of crops and the prices they command. If that part at any rate of the notes which the Bank issues to meet the need of expansion is secured by assets of a character corresponding to this need of expansion, that is, if these assets mature and are liquidated when the increased monetary circulation is no longer needed, the process of expansion and contraction becomes almost automatic. The true commercial bill, that is a bill drawn in respect of a genuine commercial transaction, has these characteristics in a pre-eminent degree. It is a

self-liquidating asset in the sense that the liquidation of the commercial transaction liquidates the bill. It is for this reason that the charters of most of the central note-issuing banks provide for their note issues to be secured partly by commercial bills. The charter of the Reserve Bank of India should contain a similar provision. With a view to promote the growth of these commercial bills we recommend that the stamp duty on bills of exchange be abolished. With the same aim, we also recommend the sale by post offices of bill forms in the English Language and the vernacular in parallel.

(Para. 130.) The Federal Reserve System possesses the quality of elasticity to a far greater extent than the fixed fiduciary system. The objection is sometimes raised that, because of this greater elasticity, it lends itself to inflation, and is therefore less to be recommended than the fixed fiduciary issue system. It may, on the other hand, be said that as the fixed fiduciary issue system can only work satisfactorily where the chief medium of payment is not the note but the cheque, the scope for inflation through an undue expansion of credit is just as great as it is in the case of the proportional reserve system, with legal tender money as the medium of exchange. *Both systems obviously require prudence in the management of currency and credit.*

(Para. 136.) Dealing with the question of the propriety of including Government of India securities among the reserves, it is easy to appreciate that they form a far less desirable asset than commercial bills, for they lack that most useful quality of the latter to expand and contract the currency automatically in accordance with the needs of the country. In the case of Government securities, expansion and contraction depends entirely upon the will and judgment of the currency authority, and is therefore more liable to errors of judgment. A large holding of Government securities, moreover, might give rise to difficulties in connection with their realisation if the need for it arose. Their inclusion among the reserve assets of the Issue Department can therefore only be justified if the amount held is limited to only so much of the circulation as is unlikely, in any circumstances, to be withdrawn, plus such further amount as can in all probability be realised without causing an undue disturbance of the Government's credit.

Even the conditional utility which attaches to ordinary securities is absent in the case of the created securities that now find a place in the Reserve. In respect of these, we recommend

that the Government should be required to replace them by marketable securities gradually within a period of ten years.

The italics are mine.

A large measure of Agreement on Principle would thus seem to have been already reached.

With regard to Para. 130 above, I have already suggested in Chapter XII the amendments that will be required before the inflationary tendencies known to exist within the financial system of banking can be removed.

After the Governments of India and China have agreed to adopt Central Banking practice based on the rediscounting system, with the essential safeguards, then arrangements should be made for the purchase of all the silver in circulation as currency, at the price of 16 pence gold, in exchange for a simultaneous issue of a paper currency and suitable fractional token coins, all in accordance with the Central Reserve Standard.

The silver collected by the Governments of India and China, and which may ultimately be found to be surplus to token coin requirements, should be held by the Central Reserve Banks as cover against the note issues, and not sold, unless the price exceeds 18 pence per fine ounce. The stocks of silver could gradually be used in later years for token coins; but even if it took a century to use up the silver in this way, it should be held. Not more than 1/100th part of the silver reserves should be sold in the open market in any one year.

In the event of any losses accruing on the silver held by the Central Bank as cover against the notes issued, the Governments of India and China should make these good by the deposit of gold, or sterling, dollar, and franc securities, of a value equal to the fall in the value of the silver. It may be permissible for the Government to deposit its own securities as a temporary expedient, provided they are replaced within six months by the eligible

foreign securities specified. This would be no hardship on the Governments, in view of the prosperity and political tranquillity that would ensue. The increase in annual revenue would be greater than any conceivable loss that might arise from a fall in the value of the silver.

In order to ensure the convertibility of the Indian currency into gold, Great Britain should arrange for the provision of the necessary gold and/or credits through a loan of £100,000,000 to the Government of India. The loan might be arranged in the New York and Paris markets, should conditions prove to be unsuitable in London.

In order to ensure the convertibility of the Chinese currency into gold, a joint loan of £100,000,000 should be raised through the Bank of International Settlements for account of the Chinese Government, the proceeds to be placed at the disposal of its Central Reserve Bank.

The World Powers should also agree to restore silver as the metal for the largest of their fractional token coins, and for a period of five years to purchase their silver requirements from the Indian and Chinese Central Reserve Banks. In later years, when the economic positions in India and China have adjusted themselves, any nation may then return to a less expensive material than silver for its largest token coins. The urgent need in the immediate present is to restore prosperity in India and China by accelerating consumption.

Currency Note Issues

As provided for in the report of the Royal Commission on Indian Finance and Currency, the Central Reserve Banks of India and China—

> should not reissue notes except in a condition as good as new. Torn or partially defaced notes should be destroyed, and pro-

vision should be made by the Reserve Banks for the disinfection and sterilisation of notes before reissue.

In order to express on the face of the notes the cardinal features, *viz.*: the guarantee of Government and the fact that they are essentially Bank notes, their form should be as follows:

RESERVE BANK..........

GUARANTEED BY

THE GOVERNMENT OF................

ONE HUNDRED............

Reserve Bank of .... notes are legal tender for the payment of any amount and are convertible into silver bullion at current market value, or into gold bullion on demand by any Central Bank, in accordance with the provisions of .... Act of ....

Issued by the Reserve Bank of .... under the authority of the above Act.

....

Chief Cashier.

As all issues of the above notes would be covered to the full extent of 100 per cent. by wealth, stability in the volume of purchasing power would be assured. And if the suggested amendments to the Central Reserve Acts were adopted, as outlined in Chapter XII, all inflationary and deflationary tendencies would be removed. The 100 per cent. cover in wealth for the notes would be assured in the following way:

(*a*) Through the re-discounting of eligible commercial bills against which Bank notes would be issued or Bank deposits created.

(*b*) Silver bullion.

(*c*) Gold and/or foreign short-dated securities.

As the Governments have to guarantee all losses that may accrue from a fall in the value of silver bullion held, the par value of the currency notes in issue cannot be affected. Neither would a rise in the value of silver affect the par value of the currency, since all profits accruing on the silver bullion held would necessarily have to go to the Central Banks' reserves. The currency would thus become invariable as a measure.

In the 'Dual System' outlined, *i.e.* by separating the commercial system of banking from the financial system, we obtain the requisite expansion of currency in the shortest space of time, without inflation. Thus stability in the purchasing power of the currency, internally and externally, is maintained. The scope for inflation through an undue expansion of bank credit is considerable. But with the ratio of credit expansion regulated, there can be no scope for inflation through expansions of currency, provided the eligibility of the commercial bills re-discountable is maintained in strict accordance with the regulations laid down. With the working conditions enforced, and with the currency notes in issue covered to the full extent of 100 per cent. by wealth, there can be no undue expansion of the currency.

The 'Dual System' outlined is ideal for India and China, where, for some time to come, the chief medium of payment must be the currency note and token coins, and not the cheque.

The foregoing proposals have already been approved by the highest banking authorities in China. The Chinese authorities are opposed to bi-metallism. Even stabilisation as a local measure has very serious disadvantages, since it would tend to load China, and the other silver-using countries, with all the surplus silver produced by the mines. Hence the reason why stabilisation, if it were feasible, would necessitate the fixation

of a low price, say of 16 pence per ounce, which would be well below the cost of production of silver. The danger here, however, is that silver is a by-product in the production of copper, and the copper producers would be obliged to dispose of their silver at whatever price was ruling in World markets.

The problem of silver is not a currency one—it is a marketing one, and should be dealt with on the lines I have suggested. It would be a great mistake to encourage people to believe that China would be content to carry the 'Silver Baby' as envisaged under the policy known as bi-metallism, or even stabilisation. In the event of a breakdown of the fixed prices that might be agreed upon, the loss would fall on all holders of silver as legal tender currency. To increase the use of silver in token coins is quite another matter.

Under bi-metallism, or stabilisation, Gresham's Law is involved. Bad metal would drive out good metal. There would be quiet but effective competition between Central Banks—and even silver producers—to unload silver in exchange for gold. Whatever an international agreement might determine, there would always be a partiality for gold. The days of mono-metallism, bi-metallism, or stabilisation have gone, and, I hope, never to return. The adoption of a Central Reserve Standard by all nations would speed the parting guests.

CHAPTER XIV

THE REPORT OF THE COMMITTEE ON FINANCE AND INDUSTRY

SINCE I published my book, *The Dual System of Stabilisation*, the report of the above Committee has been issued, and certain of its conclusions and omissions call for comment. It has been said by several critics that my plea for the establishment of a Central Reserve Bank in this country has been rejected by the Committee ; on the contrary, the Committee avoided the issue. It made no attempt to tell us what was the best Central Banking System in the World, what its defects were, if any, and how these could be remedied. The supplementary evidence which I tendered last February gave them an unanswerable case.

With regard to the original evidence which I submitted to the Committee on behalf of the Federation of Master Cotton Spinners' Association, I think the following statement made by the Chairman, Lord Macmillan, will be of interest :

> Question 6856. . . . First of all, may I express to you on behalf of the Committee our indebtedness to you for the preparation of this précis, with which you have furnished us. I do not think we have ever had any evidence put before us so much *de luxe*, if I may say so.

I warned the Committee of the crisis that was impending, and all that it has given us is a new theory to study which has no relation whatsoever to existing tendencies or facts. It does not come within the scope of practical banking, and bankers are by nature conservative. They would certainly be most unwilling to embark on the

development of a new theory the end of which they could not foresee. Improve on what the bankers are now doing and progress will be assured. Common sense would have suggested this to be the only practical policy to pursue, but the Committee ordained otherwise.

It is most difficult to appreciate the attitude of the Committee in this matter in view of its declaration in para. 6, p. 3, as follows :

> In view of the generally uninstructed state of the public on matters of finance we have from the outset recognised that not the least important service we might render would be to act as interpreters of the working of the monetary system and to make its main principles intelligible to the ordinary mind.

I suggest that the Committee has failed in this part of its duty, if it has failed to interpret the working of the Federal Reserve System and the French System. The public would like to have known—Which system, in the opinion of the Committee, was the best in the World ? What defects it had, and how these could be remedied ? As will be seen later, the Committee departed from its declared intention, and have instead given to the public a new theory to digest which goes quite outside the scope of the immediate experience of bankers generally.

If the Committee had had the interests of the producers and traders of this country at heart, I should have thought that the following questions and answers would have merited favourable consideration. They occurred during my examination by the Committee :

Questions by Lord Macmillan

6873. 'Would one of the first practical steps in your programme be to require the banks to cease giving overdraft facilities ? '—Against credits which are to be used for agricultural, industrial, or commercial purposes.

6874. 'The difficulty is this, that at the present moment the

agriculturist or the commercial man works on an overdraft at the bank ? '—Yes.

6875. 'No bill comes into existence at all. Is it an essential part of the mechanism of your scheme that the system of financing by overdraft should be superseded by a system of financing by bills ? '—Yes.

6876. 'In order that these bills as instruments of credit may come into existence and pass through the mill and be, in transit, the backing of credit ? '—Yes, and be eligible for re-discount at the Bank of England.

6877. 'And be the foundation of the credit structure ? '—And be the foundation of the credit structure.

6878. 'That is to me quite intelligible, but how do you propose to achieve that ? Would you put an embargo on the banks granting facilities by way of overdraft ? '—You would achieve that, surely, through your Central Banking mechanism—the regulations which you may adopt for that purpose.

Question by Mr. Cecil Lubbock

6899. 'The bill, of course, would then be endorsed by the joint stock bank ? '—By the joint stock bank, without any risk to the Central Bank.

Questions by Mr. McKenna

6900. 'Have you considered at all why the bankers do not discount at the Bank of England ? '—I believe it is a matter of etiquette or the rule of the market ; or a matter of etiquette in the discount market.

6901. 'Let us look at it another way. The good bank bill which the Bank of England would take would be discounted to-day by the banks at the present market rate of 2½ per cent. If we re-discounted it with the Bank of England, we should re-discount at a minimum of three per cent. ? '—Why 3 per cent., Mr. McKenna ?

6902. 'Would there be any good reason why we should not re-discount with the Bank of England at 3 per cent. ? '—Yes, a very good reason.

6903. 'You cannot re-discount at less than three. The good bank bill which the Bank of England would take can be discounted by the joint stock bank for 2½ per cent. ? '—Yes.

6904. 'The bank discounting at 2½ per cent. cannot afford to re-discount at 3 per cent. ? '—That is in the case of a bill, but in the case of the overdraft, which we are discussing, you are paid

5 per cent. at the present time, so you could afford to re-discount at three, if that were the rule under the new system.

6905. 'The banks would not charge 5 per cent. if they had a due date for payment. Your promissory note has a due date for payment, and if it were of such quality as the Bank of England would take up, we should be quite willing to discount it at the present time at $2\frac{1}{2}$ per cent.'—I quite follow.

6906. 'Five per cent. is not the bill rate?'—No, quite. There should certainly be a profit in favour of the joint stock banks when they come to re-discount at the Bank of England. They cannot be expected to assume the liability involved in their endorsement without compensation.

An offer to discount eligible commercial bills at a rate at least 50 per cent. under the present overdraft rate should surely have merited serious consideration. Had the producers been adequately represented on the Committee, the point would certainly not have been ignored.

Perhaps the reason the Macmillan Committee had for not expressing a considered opinion on Central Banking practice based on the re-discounting system is to be found in the conclusion expressed in para. 391, p. 169, of their Report, as follows:

As such advances form the most lucrative part of their assets, the banks indeed are very willing to do so, *so long as their total lies within their customary percentages* and within the limits set by general credit policy. . . . In general, we are satisfied that, *subject to the conditions imposed by the necessity of accommodating ourselves to the outside World*, our banking system is adequate and satisfactory in the provision of the normal short credits to industry and their distribution.

The qualifications here are those I have placed in italics. International financial considerations are to have preference over industry, and the claims of the latter are to be subject to the customary percentages to which the banks work in this matter. Yet the Bank of England 'looks to the joint stock banks for guidance as to the needs of industry.'

Now let me deal with the main assertion that there is a sufficiency of credit for domestic purposes, and show how the Committee contradict themselves :

(Paras. 224–5, p. 99.) Thus the effect of credit expansion or contraction on the amount of business advances will be mainly indirect. . . . Finally, the diminished (or increased) profitableness of business will diminish (or increase) the desire to embark on new investment propositions. Thus what started as an alteration in the *supply* of credit ends up in the guise of an alteration in the *demand* for credit.

It is for this reason that controversy is apt to arise as to the connection between business depression (or the opposite) and the policy of the banking system in decreasing (or increasing) the volume of credit. For example, it has been put to us, on the one hand, that the maintenance of the basis of bank credit, and therefore its volume, at the actual figures of recent years instead of at some higher figure, however inevitable it may have been, has had an important influence in depressing British business and in causing unemployment. On the other hand, there has been a decided preponderance of evidence from banking quarters to the effect that sound borrowers for purposes of a kind which it is suitable to finance by means of bank loans have seldom or never been refused adequate accommodation by their bankers. Broadly speaking, the evidence which we have received from business quarters has also supported this view. But these two views are, for the reasons just given, not necessarily inconsistent with one another. For it is a usual characteristic of a process of restriction to reduce business profits below normal, just as it is a usual characteristic of an inflationary process to swell them above normal ; and the reduction of profit naturally diminishes the eagerness of the business world to expand the scale of production or to seek bank advances on a larger scale. Indeed anyone would expect that a restriction of credit, once it was well under way, would greatly diminish the pressure on the banks for new advances for the purposes of business expansion. Thus it would be a mistake to conclude from the absence of such pressure that a restriction of credit has, therefore, had no adverse influence on the volume of output and employment.

The Macmillan Committee have thus confirmed the point I have laboured to develop, namely, that when a contraction of credit is entered upon for financial reasons,

the producers and consumers are made to suffer a contraction of commercial credit, even though they have been innocent of the cause which promoted the need for a contraction of credit ; and that when they have been thoroughly exhausted and unable to ask for credit facilities —not being credit worthy—they are then told there is a sufficiency of credit for all sound business propositions.

Therefore I quite agree with the Macmillan Committee when it says 'that financial policy can only be carried into effect by those whose business it is.' The only qualification I have to add is that it entirely depends upon the interests it serves.

I have always said that the evidence against the bankers' hypothesis was conclusive. It was not in their power to extend the base of credit, *i.e.* create currency £s, which is the vital point in the argument.

Consumers in constant fear that they cannot get enough, and producers in constant fear that they will produce too much.

Bankers have definite fixed ratios to which they must work if they are to maintain sound banking principles, and, at the present time, they create credit £s at the ratio of ten credit £s to one of currency £s. In other words, the bankers have themselves established the temporary rule that at the present time they can risk working with a sum in cash equal to 10 per cent. of their deposits.[1] Thus the power of the bankers to create credit £s depends not only upon the sum in currency £s they may have in hand, but on the ratio at which they may agree to work. If bankers are to-day compelled to work at a ratio of 10 to 1—the lowest in history—how can

[1] Before the War the accepted practice was that bankers must hold 15·5 per cent. of cash to their deposits. The proportion of commercial credits was greater in those days. In consequence of the intrusion of the War Debt, however, and of the contraction of currency in recent years, the bankers, in order to maintain their lending power, have resorted to the expedient of working with a lower ratio of cash. It has declined gradually each year. (See p. 43.)

they possibly say 'that there is no evidence of a shortage of credit facilities'?

It is not within the power of the bankers to create currency £s, *i.e.* cash. This must always remain the exclusive business of the Central Bank. I am therefore forced to ask the question again—What is it that sells commodities and enables credit to be extended on a sound basis? Nothing but the purchasing power which emanates from a sale of commodities. But how can we extend the purchase and sale of commodities? Only by having a sufficiency of currency £s in circulation, issued against circulating commercial credits, and this is the exclusive business of the Central Bank. How, then, can the Committee and bankers justify their statement that there is a sufficiency of credit for the normal requirements of industry and trade?

The real truth of the matter is that the Committee and bankers cannot possibly determine what the normal requirements of industry and trade are, simply because they do not know what they are. They have forgotten that Britain's financial power has been built up on the strength of her productive power; just as I have shown that the financial strength of the United States and France in recent years has been built up on their respective productive powers. I have shown that the United States has an actual excess of exports of merchandise over imports of merchandise. Her exports of manufactures are greater by far than her imports of manufactures—hence the reason for her present financial power. London has lost its prestige because it has forgotten this essential need.

In view of what I have said, I should have expressed the conclusion of the Committee (as above) in para. 391, p. 169, of their Report, as follows:

In general we are satisfied that, if London is to maintain the prestige of the sterling bill on London, and her position as a world

financial centre, our Central Banking System should be so designed as to afford to industry and trade all the re-discount facilities they may require. Credit £s can only retain their value provided there is an adequacy of currency £s. An extension of production alone can create cheap sound money, without which no financial centre can prosper. London cannot maintain its financial prestige if it has to depend upon the short-term money which France and the United States are obliged to leave with it, and which can be drawn off at inconvenient moments, thus making the conduct of an international money market impossible.

I entirely agree with the conclusion of the Committee as expressed in the following, but it throws into relief the previous view expressed, 'subject to accommodating ourselves to the outside world':

Nevertheless, it was clearly in France's interest not to attract gold from abroad in excess of what the Bank of France really wanted. For the influx of gold was calculated to produce three sets of consequences detrimental to French interests :

(*a*) It was likely to cause an unwanted expansion of credit within France.

(*b*) It was likely to injure the French export trade by lowering foreign prices relatively to French prices and contracting the volume of demand.

(*c*) It was likely to have a seriously disturbing effect on the stability of the existing settlements of War Debts.

It follows, as M. Moret, the Governor of the Bank of France, has pointed out in his review for the year 1930, that there was no way to harmonise the interests of France and those of the rest of the World except by an increase of French foreign investment at long term, corresponding to the increase in France's foreign favourable balance *in excess of her desire for imports whether in the form of commodities or gold.*

This conforms to that part of my thesis which I have developed in Chapter XI, likewise the following :

Moreover, the influx of short-term foreign balances under the influence of a temporary attraction is, and should always be regarded as, the equivalent of a *negative* gold reserve and consequently as a potential source of future weakness.

The bankers in the City have always regarded the

influx of short-term foreign balances as being of great advantage to London, but I think I have definitely exploded this view in Chapter XI. Nevertheless, I am perplexed about the Committee's other attitude 'subject to accommodating ourselves to the outside world.' How is London to carry on its foreign lending, carry our £4,000,000,000 of foreign investments, without these short-term deposits? London has made its money by borrowing short and lending long. The answer would seem to be that for the future we must create out own short-term money through a re-discounting system. We should then be assured of all the cheap money we require, and we should have the satisfaction of knowing that it was our own money.

In its discourse on the general characteristics of monetary systems the Committee have the following observations to make (p. 11), and in view of what I have said in the earlier chapters, particularly Chapter IX, the conclusions in the report were, for the most part, bound to be erroneous if they were to be founded on these premises:

> Whereas in the nineteenth century, the symbols (pound sterling, dollar, etc.) expressed values corresponding to coins actually in circulation, this is not often the case in the modern world. To an ever-increasing extent, paper representatives of the monetary unit constitute the hand-to-hand currency in circulation. The symbolic character of the monetary unit has emerged into the foreground while its relation to some actual physical material has receded.
>
> In the modern world payments are effected by cheques or similar means to a far greater extent than by cash, though the extent to which substitutes for cash are employed varies in different countries. Thus the mass of purchasing power in a modern community is still further removed from the physical objects with which it is linked through the monetary unit.
>
> The devices mentioned above are very important in that they have given great elasticity to the volume of purchasing power.

I agree that the devices mentioned above are very important and that they have given great elasticity to the

volume of purchasing power, but to purchasing power of the wrong kind. I have shown that there is a great difference between unregulated credit £s and fiduciary currency £s on the one hand, and regulated credit £s and standard currency £s on the other. The root cause of the World's difficulties to-day is, and I agree with the Committee in this respect, 'that the mass of purchasing power in a modern community is still further removed from the physical objects with which it is linked through the monetary unit.' The Committee should have said, 'with which it is *supposed* to be linked.'

From the argument as I have developed it, it will be seen that I am entirely opposed to the Committee's view. It will be obvious that the symbolic character of the monetary unit should recede more into the background and not emerge, because the volume of credit throughout the World to-day is more than can be sustained by the volume of currency, particularly as the latter is mostly of a fiduciary type. The paper representatives of the monetary unit should be increased in volume, and be wholly related to actual consumable wealth, that is, physical material. The currency £s in issue should be a representative currency, and invariable as a measure of value (see Chapter IV); and the credit £s in issue should be regulated in accordance with the regulations outlined in Chapter XII. It is in the interests of all holders of credit instruments that credit should be regulated and standard currency created, and that an appropriate balance should be maintained between the two, so as to ensure that standard currency may circulate as the true measure of *all* value. The physical and mechanical facts in one sphere of activity are related to those in all other spheres. Balance is the underlying principle in the construction of the universe, and the Committee would seem to have disregarded this aspect of the question, believing, no doubt, that the total Quantity

of Money could be regulated to accord with an index number, that everything could be managed, and that at any given moment of time the Quantity of Money was always worth exactly the total quantity of goods in process of production and distribution (see Chapter IX).

Stability should be the keynote of monetary policy. The world is to-day suffering from an excess of the devices mentioned by the Committee. Purchasing power can be manufactured too easily within existing currency systems.

Another empirical device is indicated in the following observation (para. 57, p. 39):

> In general, however, it is clear that the ability of the commercial banks to grant loans to their customers ultimately depends, under existing joint stock banking practice, upon the provision of the necessary cash base by the Bank of England. If the commercial banks have made loans up to that percentage of their deposits which they have adopted as a working basis, either they must cease to grant new loans except to the extent that existing loans are reduced, or the cash base must be expanded by the Bank of England. The determination of what is an adequate supply of credit rests ultimately therefore with the Central Bank. As to the factors upon which the Bank frames its judgment we quote from Sir Ernest Harvey's evidence: 'It is to the joint stock banks that we have to look for guidance as to the needs of industry for an increased volume of credit or for signs that the volume of credit is in excess of requirements. . . . The barometer to which we look is the volume of money that is seeking investment in the short market, presumably for the reason that, except in so far as additional short assets may be necessary for the restoration of banker's proportions, the funds in question cannot find employment elsewhere than in the short market. . . . We look to the volume of private deposits considered in conjunction with conditions in the money market, and we have to measure on that basis the adequacy of the volume of credit—always, of course, having regard to the external position, the state of our reserve, the position and trend of the exchanges' (Q. 8848).

Sir Ernest Harvey states 'that it is to the joint stock banks that we have to look for guidance as to the needs

of industry, etc.,' but 'the barometer to which we look is the volume of money that is seeking investment in the short market, etc.' The joint stock banks look one way, while the Bank of England looks the other way. The joint stock banks can only attend to the needs of industry if their cash base is extended, and, as the Committee states, only the Bank of England can do this; but, as I have said, it is not for the joint stock banks or the Bank of England to try to determine what the needs of industry are in the matter of credits, for they could never determine what these are. It is for the producers and consumers to determine these for themselves, and the monetary mechanism should be there for them to use as and when it is required. All that the joint stock banks should be called upon to do is to enforce the regulations; to determine whether borrowers are credit worthy. Discretionary power should rest with the joint stock banks, and not with the Bank of England. The latter's sole business should be to maintain the invariability of the measure of value and its convertibility, and to ensure the maintenance of sound banking principles in accordance with the law. It should be concerned only with what is lawful, and with nothing else. The Central Bank should not be called upon to exercise discretionary judgment, for human judgment is not infallible. The heavy losses in which the Bank of England has involved the country in recent years by its mistaken policy should be sufficient to prove this point.

Elsewhere in the Report it is suggested that the joint stock banks should encourage the use of inland bills, but unless the joint stock banks were able to re-discount these bills they would provide no advantage over the overdraft system. The sole object of re-discounting is to provide an adequate supply of currency £s, that is, to ensure that the industrial and commercial community will receive all the currency it requires for the purpose of paying wages.

At present the banks are limited in their lending power as regards commercial credits, because of their inability to pay out a sufficiency of currency for wages. It is this handicap which causes banks, I think, to prefer financial credits, because under the latter the demand for currency is not so great. Payments are more conveniently made by cheque. It should be observed in passing that the active currency in circulation in this country has been contracted by not less than £175,000,000 since it reached its highest point on 29th December, 1920, and that credit has not been contracted proportionately (see pp. 42–4).

I agree in part with the following conclusion of the Macmillan Committee, but I strongly disagree with its implication :

> (P. 5, para. 11.) An important thing to bear in mind is that financial policy can only be carried into effect by those whose business it is. We have in this country a great financial and banking organisation with great experience and great traditions. It is through and with that organisation that we have to work, for they alone are the repositories of the skill and knowledge, and they alone possess the equipment necessary for the management of our financial affairs. Their views and opinions, however they may fail to commend themselves to enthusiastic reformers, are factors to be reckoned with just as much as the views and opinions of trade unions have to be reckoned with on questions of wages and working conditions.

No one with a modicum of common sense would disagree with this conclusion, but is it not, after all, a mere platitude ? This is an age of specialisation, and there are no finer bankers in the World than British bankers. The producers of this country, and the most ardent money reformers, would not wish to make a change in the bank's personnel, if they were to succeed in bringing about the desired reforms. The British banker can always be trusted to conduct his business according to the law of the land. But there is an implied suggestion in the

Committee's observation which the producers of this country will strenuously oppose.

What the producers want to-day more than anything else is economic freedom, and they require the evolution of a monetary system that will enable them to conduct their business without being subject to the interests of international finance. The Macmillan Committee and the bankers may honestly hold the opinion that international finance is to them paramount, and because of this may think it paramount to the welfare and prosperity of the country. They are quite entitled to hold this opinion. But they are not entitled to prevent the producers and the public from proving the alternative case, namely, that the interests of this country and the Empire are best promoted by developing production in this country to the utmost possible extent, and in promoting and consolidating Empire trade.

Let us put the best aspect upon it and say that the argument is open to a legitimate difference of opinion. Then who or what is to determine the validity of the argument? Surely the play of economic forces in a free field? If the producers and consumers of this country were given the circulating credit facilities which they could have had if the financial system of banking did not exist, then they would have an opportunity of proving that national production and the promotion and consolidation of Empire trade were of more value to this country than the illusions of a monetary system that is mainly international in character, and which rests on nothing else than the business of borrowing at a low rate of interest and lending at a high one, without paying sufficiently close attention to the quality of the security. There are, of course, exceptions.

The main recommendations of the Committee are embodied in para. 286, p. 121, as follows:

The main objective of Central Banks acting in co-operation in

the management of the international gold standard should be to maintain the stability of international prices both over long periods and over short periods—*i.e.* they should both keep the average steady over a period of years and avoid fluctuations round this average from year to year. Or alternatively—if this alternative were to receive superior support—they should prevent prices from falling to a greater extent than is justified by the increase in the efficiency of production. Stability over long periods is largely a question of the adequacy of the quantity of gold available for their reserves taken in conjunction with the proportionate volume of credit created on this basis; stability over short periods, or in other words the mitigation so far as possible of the Credit Cycle, is, we believe, largely a question of co-operative monetary management.

But while these objectives can be simply and shortly stated, the difficulties in completely achieving them are great and manifold.

The Committee recognised that the difficulties to be encountered in connection with the development of their pet theory were 'great and manifold,' but why did they put the theory forward when they knew of the impending disaster Great Britain was threatened with? They were appointed for the purposes of suggesting an immediate practical policy, but chose instead to bewilder the masses with their theory for a stabilisation of a general average of world prices.

In my book, *The Dual System of Stabilisation*, pp. 138–40, I give the reasons[1] why we cannot agree to the stabilisation of a general average of world prices, the most important of which is as follows:

Even if the purchasing power of the pound were stabilised by an international arrangement, there could be no guarantee that the average price of commodities in all countries could be fixed at a given standard level. Costs of production will be higher in one country than in others, as is the case with Great Britain at the present time. A violent movement (or variation) of prices could occur within a stable purchasing power, and thus certain com-

[1] These were also given in my evidence to the Committee on Finance and Industry.

modities may be dearer in one country than in another. To allow prices to find their own natural level, subject to profit, is the most certain way of eliminating irregularities of this kind.

Assuming also that agricultural prices were higher in this country than in others, which would be possible under a stabilised average of prices, then costs of production would be higher in this country than in others. As Euclid would say, the proposition is absurd.

The economists and bankers who support the new theory were originally orthodox free traders, and they would seem to have put it forward in the hope that it would avoid the necessity of recognising the realities which exist in the outside world to-day. They are reluctant to give up their orthodoxy, and, like Micawber, would seem to be waiting for something to turn up. If they had any hope of being able to force France and the United States to their views, they were indeed optimists. I do not for one moment suggest that, when the World reaches a more advanced stage of civilisation, international freedom of trade may not come, but before this could be made possible we must attain a more perfect balance as between the divisions and subdivisions of labour and finance. We must take the World as we find it, and not as we hope it may be.

The greatest objection to stabilising a general average of World prices is, that money would continue to control the prices of commodities. Price and Value would be maintained as separate factors. The ideal which all practical economists have had for years is that 'price' and 'value' should be merged into 'Price-Value.' The ideal concept is that the control of prices of commodities should be transferred away from money to the producers—the natural controllers. In a proper barter system of economy, the producers alone pre-determine their own price-values in the process of exchange. Production is carried on for the purpose of exchange, and

all that currency is required for is to facilitate the processes of exchange.

Furthermore, in the conception as visualised by the Macmillan Committee, the international control of gold is presupposed, and this, if it took place, would result in all nations losing their economic and political independence. The Conservative Party, for instance, would have to have more limited ambitions in regard to the development and consolidation of Empire trade.

The root cause of the present world crisis is that nations have been creating credits in excess of the currency requirements necessary to support them. The World is suffering from an excess of debts and interest charges, which can only be discharged by its productive power. And a certain group of economists and bankers are suffering from the crazy notion that the disease can be cured by the creation of further debts, which they aptly call an increase of investment. They are internationalists of the wrong kind. I am not suggesting that lending for productive purposes is not good business—on the contrary. But lending of the kind that London has been indulging in for the last few years is the worst type of business.

Even lending for capital purposes, within an inelastic system of currency, is bad business. In Great Britain, for instance, the credit system is choked with securities of all kinds. The subscribers of the loans floated for capital purposes would require credit facilities, and they would have to obtain them, if the securities were to retain their marketability and liquidity. It is not credit £s we require to create but currency £s, and until we create more of the latter based on wealth, loans for capital purposes could not assist in reducing unemployment or in promoting prosperity. An increase of loans under existing circumstances would simply have the effect of reducing the prices of other securities not equally good.

This is an implication of the 'Quantity Theory of Money' not yet understood. It is Gresham's Law restated, namely, good securities will drive out inferior ones. Likewise good loans will drive out inferior ones. Hence the reason why bankers say that credit is never refused to sound business propositions.

A most excellent rapier thrust is made by Lord Bradbury in a footnote in his dissenting memorandum published in the Macmillan Report (p. 280) as follows :

> I have not space for a critical examination of the doctrine of the new school of economists that the profits resulting from capital expenditure will themselves provide the savings to finance it. The cynical maxim ' let us eat and drink, for to-morrow we die ' has at least the common sense to recognise by implication that difficulties may arise from the policy if death fails to ensue.

I also agree with the following very sound opinion expressed on the same page by Lord Bradbury :

> If there were substantial reason to hope that works of this character would permanently reduce unemployment and so save an appreciable proportion of the present expenditure on relief, it would be worth incurring this latter risk, but I am not satisfied that real savings sufficient for any considerable effort on these lines are in fact available. Savings are hard to make in hard times. Unless they are available, it is not feasible to start a lasting trade revival by intensive capital expenditure at home. The essence of such expenditure is that it does not create an immediately saleable product. The expenditure itself, however, is in the main, through wages, upon articles of consumption, and, through materials, upon other immediately saleable products some of which are available for export. It will stimulate production at a rising level of prices of the articles of consumption and materials, it will also encourage imports and diminish exports in the industries immediately affected and increase costs in other industries. It will, in fact, have an inflationary effect comparable with that resulting from the issue of forced currency.

I do not agree with Lord Bradbury where he states that, with a strict control of currency, a large degree of freedom can safely be given to credit.' This is a re-

capitulation of the rule laid down by Sir Robert Peel (see pp. 26–7) based largely on the works of John Stuart Mill.

With a strict control of financial credit, a large degree of freedom can safely be given to currency, provided it is covered to the full extent of 100 per cent. by eligible bills of exchange. Eligible commercial credits can only be properly financed by the currency, which should be the measure of value of existing circulating credits, and therefore the measure of all other transactions. Production is service power and is carried on for purposes of exchange, and the only instrument that can facilitate a barter economy is the currency note. It is thus, or should be, a circulating commercial credit.

And after all, have the Macmillan Committee not tacitly admitted this principle in para. 370, section 6; p. 159, of their Report?—as follows:

> We think that there might sometimes be an advantage in allowing a slight elasticity on the initiative of the Bank of England in the reserves recommended above for the joint stock banks. That is to say, the power to relax or tighten up this figure might be a useful addition to the Bank of England's means for affecting a relaxation or contraction of credit. We make the suggestion, therefore, that as to a variation within certain narrow limits, the banks should accept the advice of the Bank of England as to the average figure at which they should keep their reserve balances—the Bank indicating to them from time to time the advisability of a change (which probably should be quite small on any one occasion). The advantage of this technique, as compared with open-market operations, would lie in the fact that the Bank of England is somewhat narrowly limited by custom in the classes of securities which it can buy or sell, whereas the effect of an alteration in the reserve proportions of the joint stock banks could be spread over the whole of the assets of those banks.

This accords with the evidence which I tendered to the Committee.

From what I have said, and may I say from what

the Committee have said, the National Government will not be free to carry into effect the promotion and consolidation of Empire trade on the lines which it has indicated. The Committee have clearly stated that it favours the raising of world prices presumably through a Central Authority, such as the Bank for International Settlements, and if the National Government agreed to this, its objective policy would always have to be subject to the policy of the Central Authority. The absurdity of the suggestion is too manifest, and we need not waste much time on it.

But if it be our intention to discard the idea, what do we propose to put in its place, since the Committee agree that the mechanism of the existing monetary machine cannot remain as it is? The National Government cannot agree to a modified form of inflation as recommended by the Committee with a view to raising internal prices, since this would raise costs and put the exporting industries out of business. Nor can it agree to the implied suggestion that tariffs should also be imposed for the purpose of assisting in raising prices, and thus reducing the purchasing power of wages. If the National Government were to support such views it would be condemned by the working classes as being the upholders of the worst defects of the capitalist system. And the working classes would not be far wrong.

There is only one thing the National Government can do, and that is to adopt a Central Reserve Standard on lines which I have suggested herein. There is no alternative proposal of a practical nature before it for consideration at the present time, and I am satisfied that none will be forthcoming.

In support of this view I will now conclude with two further quotations with which I cordially agree. In para. 12, p. 6, the Committee make the following observation :

We recognise that the present inquiry was instituted in consequence of the abnormal industrial depression and extensive unemployment prevailing at the time of our appointment, and in the hope that we might be able, as the result of our examination of the financial aspect of the problems involved, to devise—if not remedies at least aids to recovery. The situation in the closing months of 1929 was already sufficiently grave. But the difficulties with which we were then faced were to a great extent peculiar to this country and were not shared by the World at large. Since the date of our appointment, however, the position has changed both in kind and in degree, and there have supervened upon our domestic difficulties grave disturbances of the economic world as a whole. This change of circumstances has necessarily altered the focus of our inquiry, as the domestic problem has tended to be overshadowed by the international situation. Nevertheless, however much we may attribute the aggravation of our industrial depression and unemployment to what it has now become popular to call 'world causes,' *there remain in the background those domestic causes which at the time of our appointment had already brought about the grave result of over a million unemployed and which, if not remedied, will continue to operate in our own case even if those 'world causes' are redressed.*

The italics are mine. And, in order to avoid any misunderstanding, I should add that when the last Conservative Government retired from office, there was over a million unemployed.

In his dissenting memorandum, p. 279, Lord Bradbury arrives at the following conclusion with regard to the Committee's Report, which I endorse :

The Report contains proposals relating to International Monetary Policy of a Permanent Character, proposals relating to International Monetary Policy to meet the present emergency, and proposals relating to Domestic Monetary Policy of a Permanent Character, but there are no proposals relating to Domestic Monetary Policy to meet the present emergency.

Without a Domestic Monetary Policy to meet the present emergency it is certainly not possible to formulate an International Monetary Policy.

CHAPTER XV

ON PLAYING THE GOLD STANDARD GAME

I THINK it is clear that the Committee on Finance and Industry have signally failed to provide us with a report based on their terms of reference, which were ' to inquire into banking, finance, and credit, paying regard to the factors both internal and international which govern their operation, and to make recommendations calculated to enable these agencies to promote the development of trade and commerce and the employment of labour.'

The Report as issued concentrated too much on international finance and not sufficiently on the internal commercial credit situation from the development of which alone would it be possible to ' promote the development of trade and commerce and the employment of labour.' Had the Committee concentrated more on the internal factors, I venture to suggest the crisis of the £ would not have arisen.

The Committee became obsessed with the idea that France and the United States were not playing the gold standard game. I do not agree with this view. I think they played it with an artistic finish. If they succeeded in outwitting us that is the fault of those responsible for the management of our monetary policy.

According to the Committee—

> there are ' rules of the game ' which, if not observed, will make the standard work with undesirable, rather than beneficial consequences. It is difficult to define in precise terms what is implied by the ' rules of the game.' The management of an international standard is an art and not a science, and no one would suggest that it is possible to draw up a formal code of action, admitting of no

exceptions and qualifications, adherence to which is obligatory on peril of wrecking the whole structure.

I do not agree 'that the management of an international standard is an art and not a science,' for the implication here is that the success of a given monetary policy must always rely upon human judgment, which is not infallible. A mistake in human judgment may wreck in an evening all that has been built up through centuries of work. And has the history of the last few years not proved this to be the case? The proof of the pudding is in the eating—we have been forced to abandon the gold standard because we were unable to play the 'rules of the game' as skilfully as France and the United States have played it. Why? I think I have explained the reason.

One of the 'rules of the game' which it is held that France and the United States have not played was in not allowing their imports of gold to inflate internal prices. But under the re-discounting system this was a physical impossibility for reasons which I have explained, and which I made clear to the Committee. All that the imports of gold could do, and it is what actually happened, was to inflate security values. This form of inflation was carried to such heights in the United States that in 1929 the bubble burst, and she has not yet recovered from the disaster.

But even had it been possible for the United States to have allowed imports of gold to inflate commodity prices, why should she? Upon what ground of commercial morality could it be held that the successful businesses built up by American producers should temporarily be put out of business in order that British producers might be assisted out of their embarrassments, which have been induced by faulty monetary policy? The suggestion is too absurd to stand a moment's considera-

tion. Great Britain's attitude in this matter has been most undignified, and I sincerely regret that the Committee on Finance and Industry should have placed her in this position.

As Dr. Anderson mentioned in *Lloyds Bank Monthly Review*, May 1930 :

> Central banks have not maintained the gold standard by regulating their supplies of means of payment with reference to the level of commodity prices. They have done a much simpler thing. They have redeemed their currency on demand in gold ! They have not worked *indirectly* from paper money *through commodity prices* to gold in the effort to fix the relation of gold and paper money. They have worked *directly*, meeting their legal obligation to redeem their promises to pay on demand, and letting commodity prices take care of themselves.

When Dr. Anderson wrote this very sound doctrine he was not visualising the system operated by the Bank of England. He had the Federal Reserve System in view, and the two systems are as different as the poles are asunder. Had the Bank of England followed such a policy as he outlines, Great Britain would not be in the difficulties she is in to-day. There would have been no crisis of the £. It has all arisen from endeavouring to set up a stream of economic theory against practical tendencies, and from forgetting that economists cannot originate economic tendencies beyond those that already exist. There are good tendencies and bad tendencies, and the good ones emanate from the barter system of economy. All the economists can do is to gather up the best of them, and shape them into an efficient mechanism. Men live by experience, and in monetary matters bankers are guided solely by this rule.

I am willing to agree that the unwillingness of the United States and France to adjust their balances of trade on the basis that imports should pay for exports must necessarily increase the burden of their debtors. But

the only way to defeat this policy is through mechanism. If we applied the Law of Detractions and Promotions as rigorously as the United States has done we should have no complaint to make.

When a country is a debtor nation, like the United States was before the War, an adverse balance of trade would be a serious matter. But an adverse balance of trade to a creditor nation can be no misfortune. On the contrary, provided she is accepting payment from her debtors in wealth which she is herself not capable of producing, it should be of the utmost advantage to her population. All that is needed is a monetary mechanism that will facilitate an equitable distribution of the wealth. It cannot impoverish a nation to receive and consume wealth that is owing to her.

CONCLUSION

I HAVE been asked to say what I would do were I a dictator. I can say with every confidence that, if I had the power, I could restore sterling to parity in the foreign exchange markets to-morrow, and be able to hold it there against any opposition or combination of circumstances. All that I need do is rigorously to apply the Dual System of Stabilisation, of which the Law of Detractions and Promotions is an integral part. I should, of course, have to discard the present inelastic monetary system, for I could not succeed if I were to attempt to reimpose the weight of debt and taxation which existed prior to 21st September last, on which date the Bank of England was forced to abandon its so-called gold standard—aptly described by *The Times* as a working myth.

I have done my best to outline the main principles involved, but owing to the vast field that has to be covered, I have been unable to deal with every phase and aspect of the remedies necessary to cure the crisis. Detractive and promotive measures must be considered on pure merit in dealing with the crisis as a whole. The objective should be to provide an assured future for mankind on a stabilised basis. Henry Ford spoke truly when he said : 'An unemployed man is an out-of-work customer. He cannot buy. An underpaid man is a customer reduced in purchasing power.' There is no reason whatsoever why we should tolerate the poverty and distress which exists. There is work for all to do, and plenty for all to eat.

Had the National Government employed the right measures when balancing the Budget, the crisis of the £

need not have occurred. This is not to say that it would not have occurred had the Labour Government remained in office. But this does not exonerate the National Government from having committed a grave error of judgment at the critical moment. The probability is, of course, that the Government would not have fallen into the error had the Committee on Finance and Industry tendered the correct economic advice. It is certain that many of the mistakes made in the past year could have been avoided.

The Labour Party rightly deplore the cuts in wages, but have they any justification for deploring it? Have they not perpetuated the free trade gold standard system which necessitates it? They must play the game according to the rules of the system which they have endeavoured to perpetuate to the best of their ability.

On the other hand, the Labour leaders rightly object to a system of import duties which aim at lowering the purchasing power of wages. For import duties to be effective they must aim at increasing the purchasing power of wages, to which no Labour leader would object if it could be realised. The Conservative leaders, I submit, have not yet proved this part of their case. They will not be able to do so until they agree to substitute a Central Reserve Standard, as exemplified by the Dual System of Stabilisation, for the present system.

If the capitalist system is the best in the world, as I believe it to be, it should be able to put forward a science of money that would get rid of Communism and Bolshevism. This can be done if a clear distinction be drawn between the uses of capital and of money.

If Great Britain had had an elastic system of currency, it would not have been necessary for the National Government to have resorted to an increase of taxation to balance the Budget. Nor would it have been necessary for certain economists to suggest that import duties

should be imposed for the purpose of reducing the purchasing power of wages. The aim of monetary science should be to distribute economic justice and not injustice. Labour works for wages, and it should be paid out of the product on which it may be employed. This can only be assured on a scientific basis when wages are paid in a currency which is based exclusively on the mass of commodities, and not mainly on Government securities. On the new basis the wage earner would be able to obtain the necessaries of life on the barter system. Anything which restricts this process of exchange, restricts production, consumption, and employment.

The science of money should be concerned with teaching us how to earn maximum wages, and how they may be spent to the best advantage. It is through wages and prices only that we may pass on to the consuming public the advantages that accrue from the improvements effected in the arts of production. Production is service power—or should be. And only when Great Britain recognises and adheres to this fundamental rule will she solve the crisis of the £.

SYNOPSIS

THE following is a synopsis of *The Dual System of Stabilisation* to which *The Crisis of the £* is a supplement. It aims at giving a rapid mental picture of the system, so to speak, and reference to the appropriate chapters are given. The main points are as follows :

(1) Every nation is entitled to a monetary system of its own. The 'Dual System' is one that can be adopted by any nation without international sanction or control.[1]

(2) The stabilisation of the £ as a measure of value at its mint parity is assured, and it can be undertaken immediately without international co-operation or support. It is not necessary to devalue a currency in order to devalue Government and Municipal securities.[2]

(3) Inflation begets deflation, and both are avoided.[3]

(4) Before the £ could be restored to parity it would be essential to convert Government and Municipal securities to a 2¾ per cent. tax-free basis. Though this arrangement would improve the present position of the holders of these securities, yet it would save the Government alone £55,000,000 a year in interest charges, and reduce the nominal value of the National Debt by approximately £655,000,000.[4]

(5) If the £ were restored to its mint parity, from its present level of 16*s*., it would save Great Britain a loss of £80,000,000 per annum which is accruing on her income from foreign investments and invisible services and a capital loss of approximately £1,600,000,000 on her foreign investments, etc.[5]

[1] *The Dual System of Stabilisation*, pp. 130–47.
[2] *The Crisis of the £*, p. 13 *et seq.*, p. 58 *et seq.*
[3] *The Dual System of Stabilisation*, pp. 127–47.
[4] *The Crisis of the £*, pp. 61–3. [5] *Ibid.*, p. 63.

(6) As credit £s are convertible into currency £s and currency £s into gold, it is no longer possible to retain gold as an international currency. It was the conversion of credit £s into gold that forced Great Britain to abandon the so-called gold standard.[1]

(7) Gold must be retained as the unit of measurement, and as a commodity for reserves, but not as the measure of value.[2]

(8) The symbolic character of the monetary unit should recede more into the background, and not emerge: there should be a definite balance between credit £s and currency £s, in order that the latter may act as a definite measure of all value.[3]

(9) The purchasing power of a currency should increase from an increase of its issue, and not decrease. This is as it should be, because an increase in the volume of production decreases the cost per unit produced, in accordance with the Law of Increasing Returns.[4]

(10) The control of 'Price' should be transferred away from money to the producers, who should have the right to predetermine their own price-values.[5]

(11) All issues of currency notes should be covered to the full extent of 100 per cent. by wealth and gold. The approximate gold reserve aimed at is £175,000,000, but without a fixed ratio and with credit controlled this provision should be sufficient. With the country's competitive power increased in foreign markets, there should be an increase in her credit balances held abroad, which to all intents and purposes are the equivalent of gold reserves.[6]

[1] *The Crisis of the £*, p. 17 *et seq.* [2] *Ibid.*, pp. 13–16.
[3] *Ibid.*, pp. 13–16, 105.
[4] *The Dual System of Stabilisation*, p. 145. *The Crisis of the £*, p. 21.
[5] *The Crisis of the £*, p. 11.
[6] *The Dual System of Stabilisation*, pp. 27–8, 96, 167. *The Crisis of the £*, p. 79.

(12) A contraction of the currency contracts consumer credit and therefore commercial credit, because consumer credit is commercial credit. Overproduction simply means that there is a shortage of consumer credit. To avoid overproduction we have to accelerate consumption, and this will only be possible whenever we bring about an increase of the active currency in circulation based on re-discounts of eligible commercial credits. In the World, and particularly in Great Britain, there is a definite shortage of commercial credits.[1]

(13) The 'Dual System' means that stabilisation is promoted in two ways, (*a*) by separating the commercial system of banking from (*b*) the financial system of banking, in accordance with the Central Reserve Standard outlined, wherein the ratio at which member banks may pyramid credit is strictly controlled. In the 'Dual System' credit is controlled and not currency, and in this way an elastic system of currency and credit is promoted. In Great Britain to-day currency is controlled and not credit, hence the reason for the inelastic system of currency which exists.[2]

(14) In the industrial sphere, stabilisation is also promoted in two ways, (*a*) by increasing wages, and (*b*) by lowering costs of production per unit of goods produced. These implications arise naturally from the separation of the commercial system of banking from the financial system. A lowering of costs of production per unit of production does not mean that wages suffer as in the case of deflation. Wealth can only be distributed through the currency. The more we can produce the more we can divide through wages. This accelerates consumption.[3]

(15) Prosperity is best promoted through increasing

[1] *The Crisis of the £*, pp. 39–57.
[2] *The Dual System of Stabilisation*, pp. 146–53.
[3] *Ibid.*, pp. 130–47.

wages consistent with maintaining competitive power. But the point of stability should be an automatic and elastic one, brought about through price tending towards lowest cost, and this natural corrective, if not counteracted by money, promotes automatic stability.[1]

(16) Automatic stability is preferable to a managed currency, since it would permit of social improvements being introduced when economic conditions permitted. The ultimate economic objective should be to shorten the working week to five days. By increasing wages and shortening the working week, we should put an effective check on overproduction. Improvements in the arts of production should be passed on to the consumer. They should not be used to accentuate cut-throat competition and unemployment.[2]

(17) Subject to item (12), overproduction can also be overcome by increasing wages, lowering costs and prices, and shortening the working week. These are the only ways by which we may pass on to the consuming public the improvements effected in the arts of production.[3]

(18) Wealth is income, and not capital. If capital produces an income, it becomes a capital asset. If it produces a loss, it becomes a capital liability. Wealth is, therefore, through the medium of commercial bills, the only proper cover for currency notes ; and if the notes are covered in this way, it can be said that they finance commercial transactions. They would, in fact, become an active circulating currency, promoting an exchange of commodities and services for commodities and services.[4]

(19) Wealth can only be distributed through the currency, and not through taxation. Taxation does not distribute wealth. The more wealth we produce, the

[1] *The Dual System of Stabilisation*, pp. 130–47.
[2] *Ibid.*, pp. 176–80. [3] *Ibid.*, pp. 176–80.
[4] *Ibid.*, pp. 81–97, 173. *The Crisis of the £*, pp. 15 *et seq.*

more we can divide. And we cannot divide until we produce. A wise Government would be that which would aim at increasing everyone's income, for then all the taxation which is imposed could be collected with greater facility and ease. A greater revenue would be assured to a Government if it lowered taxation. . . . A Government should aim to take as little as possible in the form of taxation out of income, and the income it taxes should be that of the current year only. All else is capital, and no Government has a right to tax capital with a view to spending it as revenue.[1]

(20) The weight of taxation is largely shifted to costs of production, and no conceivable increase of industrial efficiency can wholly overcome this handicap. The weight is at least 100 per cent. higher in this country than in any other country. Thus, whilst free trade is maintained, the market in this country is a better one to sell in than to buy in. In such working conditions the pressure on our gold reserves cannot be lifted, and the Central Bank will find it difficult to maintain the parity of the exchanges. [This prophecy was made in the *Dual System of Stabilisation*, written a year before Great Britain abandoned the gold standard.—J. T. P.][2]

(21) In accordance with the 'Dual System' import duties are imposed with a view to lifting the pressures on the gold reserves. But if they are imposed under an inelastic system of currency they develop 'Protection,' since 'Price' and 'Value' must necessarily be maintained as separate factors. In this event the quantity of money available for production will be called upon to finance a smaller volume of consumable wealth at higher prices. Alternatively, if the quantity of money is called upon to finance a larger volume of production, prices and wages must fall. Whatever the effect produced, unemploy-

[1] *The Dual System of Stabilisation*, pp. 61–97.
[2] *Ibid.*, pp. 61–95, 96, 115–17, 119.

ment will be perpetuated. The Dual System removes this dilemma.[1]

(22) Within an inelastic currency system the Free Traders' arguments against Protection are valid ; but they fail to notice that the implications of free trade are merely a restatement of the implications of the 'Quantity Theory of Money.' That is, if the quantity of money available for production is to do the maximum amount of work possible, the community must buy in the cheapest market and sell in the dearest. Cheapness is a relative term. It can only be determined by the relation which may exist from time to time between the commodities available for purchase and the means of payment that exist within the working community.[2]

(23) The 'Quantity Theory of Money' is given a new interpretation. Under the 'Dual System' there is substituted the 'Quantity Theory of Currency.' An expansion of financial credit will raise security prices, hence it will be necessary to control the ratio at which it is expanded. An expansion of eligible commercial credit through discount and re-discount will lower costs of production per unit of goods produced, and, as price naturally tends towards lowest cost, no control need be exercised over expansions of eligible commercial credit financed by currency. Under this system the quantity of currency in issue would have no influence whatsoever on commodity prices.[3]

(24) It is much more profitable to produce internally than to buy abroad, especially as Labour can be paid effectively out of the products on which it is employed. Production is carried on with a view to exchange. When people work for currency their ultimate aim is to obtain

[1] *The Dual System of Stabilisation*, pp. 50, 121–4, 162–8, 130–41. *The Crisis of the £*, pp. 11–12.

[2] *The Dual System of Stabilisation*, pp. 3, 121.

[3] *The Crisis of the £*, pp. 49–57.

the things that currency will buy. The active currency in circulation should be the measure of value. [It should be observed that I have used the word 'currency' in lieu of 'money' in order to define the technique involved more clearly. In the present order of things currency and credit are not equal to money. It is here that economists have gone wrong.—J. T. P.][1]

(25) It is essential that the expenditure of Government should be reduced to the lowest possible limit in order that costs of production may be lowered and wages raised to the highest point consistent with maintaining competitive power in world markets. In this way only can the nation retain what Frederick List aptly called its 'Power of Disposition.'[2]

(26) It is also imperative, in order to ensure the stability of the currency, that all inflationary tendencies should be removed, such as, for instance, the promise made by the Conservative Party to subsidise the cereal crops or to guarantee their prices. A remission of taxation is essential if costs of production are to be reduced, and the surplus revenue required should not be impaired by the promise to pay subsidies. The main business of Government is to issue regulations for the proper conduct of agriculture, industry, and trade, but certainly not to guarantee the profits of production or trade.[3]

(27) Assuming that the principles of the 'Dual System' and 'The Law of Detractions and Promotions'

[1] *The Dual System of Stabilisation*, pp. 13–16, 169.

[2] *Ibid.*, pp. 61–97, 115. [3] *Ibid.*, pp. viii, 187–90.

[4] The Law of Detractions and Promotions simply means that if purchasing power is transferred to one group of commodities or services there would be less of it to spend on others. If, for example, we buy £5,000 of motor-cars from the United States, she will have command of that purchasing power, and she can dispose of it as she wills. If she spends it here then our purchasing power is restored. In foreign trade every sale should promote a purchase or a service in the currency received from the

are fully applied, it should be possible to lower the number of unemployed persons to about 500,000 persons within the year and to induce a Budget surplus of at least £150,000,000 within two years without increasing the rate of taxation, to produce which it would be necessary to redistribute the weight of taxation so as to reduce that portion of the weight which bears directly on costs. This is most effectively achieved by transferring as much as possible of the weight to import duties, which, under the 'Dual System,' are neutral in their effect upon costs, their object being to make the foreigner bear his due proportion of the weight of taxation in exchange for the privilege of marketing his goods. This accords with the philosophy of Adam Smith.[1]

(28) As London has lost its position as the international money market, it should be established as the financial centre of the Empire, a task sufficient to restore its authority and prestige.[2]

sale. I am not ignoring the invisible services, I am now discussing the principle of the Law.

In my book, *The Dual System of Stabilisation* (Chapter XVIII), I have shown how we may deal with internal transfers of purchasing power not based on metallic money. In the event of a transfer of purchasing power to a commodity, or a group of commodities, the only way to correct it would be to increase the standard currency in circulation proportionately. This would be done automatically through the re-discounting system. It does not necessarily follow that because of an increased demand for a particular commodity, that the demand for all others has lessened proportionately. The shortening of purchasing power based on metallic money does not shorten potential demand. As I have said previously, purchasing power should emanate from a sale of commodities, that is, it should be based on actual wealth, and not on gold or silver. Without this balance we have to resort to an increase of credit, *i.e.* debts, to adjust accounts, because we cannot afford to see people starved of the necessities of life. But in the long run the debts have to be discharged by an offer and acceptance of wealth of some sort, the alternative to which is repudiation.

[1] *The Crisis of the £*, pp. 64–75. *The Dual System of Stabilisation*, pp. 162–8.

[2] *The Dual System of Stabilisation*, pp. 197–200, 213–15. *The Crisis of the £*, p. 75.

(29) While gold remains an international currency it would be impossible to have universal free trade. Freedom of trade in exportable surpluses is the true ideal, and not universal free trade, which is an impossibility. This points to the need of creating large economic units. When all currencies are based on consumable commodities, and all credit systems are controlled, it will not matter who controls the earth from an economic point of view. Wealth will be distributed through currency, and the people will own the currency. Nations large and small can then obtain their due share of the wealth which God has placed at the disposal of all.[1]

[1] *The Crisis of the £*, pp. 18–20.

'With malice toward none, with charity for all, with firmness in the right as God gives us to see the right, let us strive on to finish the work we are in, to bind up the nation's wounds, to care for him who shall have borne the battle, and for his widow and his children—to do all which may achieve and cherish a just and lasting peace among ourselves and with all nations.'

ABRAHAM LINCOLN.

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SOME PRESS COMMENTS

"Some of Mr. Peddie's criticisms of the existing monetary system are to the point, and his book may be read with profit and instruction."

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Rassequa Numismatica (Rome).

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